93-486

No. _____

SUPREME COURT, U.S.
FILED
SEP 24 1993
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In The

Supreme Court of the United States

October Term, 1993

FRANK KELLY, MARIA KELLY, JUAN ANTONIO BRANDO, BERTA LASERNA, RAFAEL DAVID POLEO ISAVA, ELLIO CIOCCA, DANIEL PRADO FLORES, MAX GOMEZ, WILLIAM MACKAY, ANTONIA MACKAY, GONZALO BARQUERO, ABRAHAM STEFAN, OSVALDO CORDOVA, RUDY ZEPEDA, THOMAS BOVEE, RICARDO SUCRE, and AGROPECUARIA MILLON, C.A., a foreign corporation,

Petitioners,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware corporation,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The United States District Court for the Southern District of Florida enjoined Petitioners from proceeding with an arbitration of their state-law claims based on a determination that those claims were barred under the doctrine of *res judicata*, notwithstanding the existence of a pre-dispute arbitration agreement which expressly permitted Petitioners to split their claims, and the Court of Appeals for the Eleventh Circuit affirmed. The questions presented are:

1. Whether the common-law defense of *res judicata* is an exception to the otherwise absolute federal policy reflected in the Federal Arbitration Act forbidding federal courts from considering or deciding the merits of disputes which fall within the scope of a valid arbitration agreement?

2. Whether the court of appeals properly found that Petitioners' state-law claims were barred under *res judicata* as a matter of federal common law notwithstanding the existence of a written agreement between the parties which expressly permitted Petitioners to raise their federal and state claims in different forums?

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MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware corporation,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners* request that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eleventh Circuit entered on June 29, 1993.

* The single corporate Petitioner has no parent companies or subsidiaries.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A) is reported at 985 F.2d 1067 (11th Cir. 1993). The opinion of the district court (Pet. App. B) is unreported.

GROUNDS FOR JURISDICTION

The opinion of the court of appeals was issued on March 15, 1993. Petitioners filed a timely petition for rehearing, *see* 11th Cir. Rule 35-6, which was denied on June 29, 1993. The court of appeals' order denying rehearing is set forth in the appendix to this petition (Pet. App. C). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The text of the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.*, is set forth in the appendix to this petition (Pet. App. D).

STATEMENT OF THE CASE

Petitioners are investors who opened and maintained securities accounts with Respondent Merrill Lynch, Pierce Fenner & Smith, Inc. ("Merrill Lynch"), one of the country's largest retail brokerage firms. As a condition of opening each such account, Merrill Lynch required each

Petitioner to execute a customer agreement which contained an arbitration clause providing as follows (emphasis has been supplied):

> Except to the extent that controversies involving claims arising under the federal securities laws may be litigated, any controversy between us arising out of such option transactions or this agreement ***shall*** be settled by arbitration only before the National Association of Securities Dealers, Inc. or the New York Stock Exchange, or an Exchange located in the United States upon which listed option transactions are executed.

Like other courts of appeals, the Court of Appeals for the Eleventh Circuit has interpreted arbitration agreements containing similar or identical language as agreements which require the parties to arbitrate all claims other than claims arising under the federal securities laws, and permit the parties to litigate federal securities claims in separate judicial proceedings if either party chooses to do so. *See Blue Gray Corporations I and II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267 (11th Cir. 1991).

Merrill Lynch invested Petitioners' funds in speculative and unsuitable investments, leading ultimately to a combined loss to Petitioners of more than $2,000,000. Alleging that Merrill Lynch had failed to disclose certain critical terms and conditions governing the trading in their accounts, Petitioners brought suit against Merrill Lynch in federal district court for the Southern District of Florida under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange

Commission Rules 10b-5 and 10b-16 promulgated thereunder.[1] Petitioners honored their arbitration agreement with Merrill Lynch by including only federal securities claims in their federal complaint. Nevertheless, Merrill Lynch was aware from the outset that Petitioners intended to assert additional state-law claims in a separate arbitration proceeding.

After a period of discovery, Merrill Lynch obtained summary judgment on Petitioners' federal claims.[2] Within three weeks of that ruling, Petitioners formally initiated an arbitration proceeding before the National Association of Securities Dealers, Inc. ("NASD") by filing a Statement of Claim with the NASD. Nearly fourteen months later, after participating fully in the arbitration process, and on the eve of the scheduled commencement of the arbitration hearing, Merrill Lynch filed an "Emergency Motion for Preliminary Injunction" in the district court asking the court to enjoin Petitioners from proceeding with the arbitration. The basis for Merrill Lynch's motion was its contention that the court's prior summary judgment served to bar Petitioners' common-law claims under the doctrine of *res judicata*. Petitioners opposed Merrill Lynch's motion and filed a cross-motion to compel arbitration, arguing (*inter alia*) that Merrill Lynch's *res judicata* defense was a matter for the arbitrators to decide

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[1] The district court had subject-matter jurisdiction over Petitioners' federal claims under 15 U.S.C. § 78aa and 28 U.S.C. § 1331.

[2] The district court's grant of summary judgment was subsequently appealed to and affirmed without opinion by the court of appeals. *Kelly v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 948 F.2d 1297 (11th Cir. 1991).

and that, in any case, the pre-dispute agreement which Merrill Lynch had required each Petitioner to sign deprived Merrill Lynch of any such defense. The district court, without benefit of oral argument or an evidentiary hearing, granted Merrill Lynch's motion and enjoined Petitioners from arbitrating their common-law claims.

In a brief *per curiam* opinion, the Court of Appeals for the Eleventh Circuit affirmed.

REASONS FOR GRANTING THE WRIT

Congress has enacted and this Court has thus far scrupulously enforced the rule that, when presented with a dispute falling within the scope of a valid and enforceable arbitration agreement, "a federal court may consider *only* issues relating to the making and performance of the agreement to arbitrate." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967) (emphasis supplied). With barely a nod to this paramount federal policy, the district court and the court of appeals have carved out a broad and unprecedented exception to this rule for matters involving the affirmative defense of claim preclusion. That rule deprives private parties of their contractual right to have such a defense decided by means of arbitration and disserves the policies underlying the Federal Arbitration Act.

The holdings of the courts below do as much violence to the federal common law of *res judicata* as they do to the Congressional policy in favor of enforcing privately negotiated arbitration agreements. It has never

previously been doubted that where, as here, "[t]he parties have agreed . . . that the plaintiff may split his claim," the ordinary rules of claim preclusion do not apply. Restatement (Second) of Judgments § 26(1)(a).[3] Yet the lower courts in this case have upheld a defense of *res judicata* in the face of a formal, written agreement which not only *permitted* but effectively *required* Petitioners to split their claims.

The court of appeals' decision in this case is unprecedented and in square conflict with holdings of this Court and other courts of appeals. Moreover, it involves issues going to the heart of two important bodies of federal law. We respectfully submit that this Court should review the decision of the court of appeals to settle these substantial and important legal questions.

I

The Court of Appeals Created an Unenacted Exception to the Federal Arbitration Act Which Merits Review by This Court

Section 2 of the Federal Arbitration Act, 9 U.S.C. § 2, provides in relevant part that a "written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." "By its terms, the Act

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[3] The text of section 26 of the Second Restatement of Judgments is set forth in the appendix to this petition (Pet. App. E).

leaves no place for the exercise of discretion by a district court, but instead mandates that district courts *shall* direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed." *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985) (emphasis in original).

It is *undisputed* in this case that: (i) the parties executed written arbitration agreements falling within the scope of the Federal Arbitration Act; (ii) no grounds exist at law or in equity for the revocation of those agreements; and (iii) Merrill Lynch's asserted *res judicata* defense is among the issues which the parties agreed to arbitrate.[4] Under these circumstances, the district court was required both by the Act itself and by an unbroken line of federal interpretive authority to refer Merrill Lynch's defense to the NASD arbitrators, as Petitioners requested. In refusing to do so, the courts below committed fundamental and precedent-setting error.

The court of appeals itself acknowledged "the general rule . . . that, while federal courts can decide if an issue is arbitrable or not, they cannot reach the merits of arbitrable issues," but went on to find that "the better rule is that courts can decide res judicata." 985 F.2d at 1069.[5] Federal courts of appeals, however, are not free to

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[4] Indeed, Merrill Lynch recognized the arbitrability of this defense when it raised the defense in its answer to Petitioners' Statement of Claim before the NASD.

[5] The unreported district court decision cited by the court of appeals as supporting Petitioners' view squarely considered and rejected the position adopted by the courts below. None of the other cases cited by the court of appeals is on point. In *Miller*

" 'substitute [their] own views of economy and efficiency' for those of Congress" and this Court. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. at 217 (quoting *Dickinson v. Heinold Securities, Inc.*, 661 F.2d 638, 646 (7th Cir. 1981)). Nothing in the language or structure of the Act provides so much as a hint that matters of *res judicata* are an exception to the statutory policy requiring enforcement of private arbitration agreements. The Eleventh Circuit's ruling that the defense of *res judicata* (alone among the universe of possible defenses) is exempt from the prescriptions of the Arbitration Act ignores fifty years of federal precedent and contravenes this Court's teaching that questions of arbitrability should be addressed "with a healthy regard for the federal policy favoring arbitration." *Moses H. Cone Mem. Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983).

Brewing Co. v. Fort Worth Dist. Co., Inc., 781 F.2d 494 (5th Cir. 1986), the court found that the plaintiff had waived its right to arbitration by filing and pursuing a state-court lawsuit – an issue which the Federal Arbitration Act commits to the federal courts. The court's further discussion of *res judicata* was *dictum*. Similarly, in neither *New York State Ass'n for Retarded Chidren v. Carey*, 456 F. Supp. 85, 96 (E.D.N.Y. 1978), nor *City of Rochester v. AFSCME*, 54 A.D.2d 257, 388 N.Y.S.2d 489, 491 (App. Div. 1976), did the court actually usurp the arbitrator's authority to resolve a defense of *res judicata* to arbitrable claims. Both New York cases rely on and misinterpret *Rembrandt Indus., Inc. v. Hodges Int'l, Inc.*, 38 N.Y.2d 502, 381 N.Y.S.2d 451, 344 N.E.2d 383 (1976), which held only that the preclusive effect of a prior arbitration award was subject to judicial determination where the allegedly repetitive proceeding was brought in court. By that reasoning, Merrill Lynch's supposed defense should have been resolved by the arbitrators.

Moreover, this Court has made it clear that the federal policy which underlies the Act outweighs any federal interest in judicial economy. Prior to this Court's decision in *Byrd, supra,* the Eleventh Circuit and other federal courts had adopted the doctrine of "intertwining," under which those courts refused to order arbitration of arbitrable state-law claims asserted in conjunction with (then non-arbitrable)[6] federal securities claims, principally on the ground that permitting "bifurcated" judicial and arbitral proceedings would be uneconomical and inefficient. In *Byrd,* this Court rejected that doctrine and held that such considerations were insufficient to overcome the paramount federal policy favoring enforcement of valid arbitration agreements:

> The preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is "piecemeal" litigation, at least absent a countervailing policy manifested in another federal statute. . . . By compelling arbitration of state-law claims, a district court successfully protects the contractual rights of the parties and their rights under the Arbitration Act.

470 U.S. at 221. *See also id.* (the possibility of bifurcated proceedings " 'occurs because the relevant federal law *requires* piecemeal resolution when necessary to give effect to an arbitration agreement' ") (quoting *Moses H.*

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[6] At the time the doctrine of "intertwining" arose, federal securities claims were considered to be non-arbitrable under *Wilko v. Swan,* 346 U.S. 427 (1953).

Cone Memorial Hospital, 460 U.S. at 20). Ignoring *Byrd*, the lower courts in this case have declined to enforce a valid arbitration agreement in an effort to avoid " 'piecemeal' litigation."

Under heretofore-established federal law, a federal court's "sole function is to determine whether arbitration should be commenced; [it] play[s] no part in determining the strength of claims and defenses presented." *City of Meridian, Miss. v. Algernon Blair, Inc.*, 721 F.2d 525, 529 (5th Cir. 1983). On that view, the strength of Merrill Lynch's *res judicata* defense was a matter reserved to the arbitrators. By hearing, considering and ultimately accepting Merrill Lynch's contention that it has a dispositive defense to Petitioners' arbitrable claims, the lower courts short-circuited the arbitration process and disregarded Petitioners' right to an arbitral determination of that defense. This Court should grant certiorari to preserve the primacy and vitality of its precedents on the obligation of federal courts to enforce valid, privately negotiated arbitration agreements.

II

In Upholding Merrill Lynch's *Res Judicata* Defense, the Court of Appeals Ignored the Effect of the Parties' Agreement and Did Violence to Accepted Principles of Claim Preclusion

Having determined (incorrectly) that the district court was empowered to rule on the merits of Merrill Lynch's asserted *res judicata* defense, the court of appeals went on to hold that Merrill Lynch was entitled to rely on

such a defense despite its prior written agreement permitting Petitioners to split their claims. In so ruling, the court of appeals reached an illogical result which penalizes litigants for honoring their contractual commitments and will only serve to make additional work for the federal courts. The lower courts' unprecedented construction of the federal law of *res judicata* conflicts with the holdings of other circuits and warrants this Court's review.[7]

The conceptual difficulties inherent in the Eleventh Circuit's ruling are reflected in its opinion. The court forthrightly acknowledged the crucial and dispositive fact on which our argument rests: "The [Merrill Lynch arbitration] agreement . . . *allowed plaintiffs to institute two suits based on the same events.*" 985 F.2d at 1070 (emphasis added).[8] The court's inquiry should have ended there. Its assertion a sentence later that "[n]othing shows that the

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[7] This Court has traditionally exercised close control over the development of the law of *res judicata* as applied in the federal courts. *See, e.g., Parsons Steel, Inc. v. First Alabama Bank*, 474 U.S. 518 (1986); *Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373 (1985); *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981); *Montana v. United States*, 440 U.S. 147 (1979); *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322 (1979); *Blonder-Tongue Laboratories, Inc. v. Univ. of Illinois Foundation*, 402 U.S. 313 (1971).

[8] This concession was virtually compelled by the Eleventh Circuit's prior holding that the language of the Merrill Lynch arbitration agreement "clearly provide[s] for state law claims to be arbitrated, even those which arise out of the same transactions or occurrences as federal securities law claims." *Blue Gray Corporations I and II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267, 271 (11th Cir. 1991).

parties understood . . . that the end of the first action would not preclude the start of the second" simply disregards the fact that a plaintiff can *always* "institute two suits based on the same events." The only legal impediment to such a course of action is the defense of *res judicata*. If the Merrill Lynch arbitration agreement "allowed [Petitioners] to institute two suits based on the same events" but at the same time permitted Merrill Lynch to defeat such an undertaking by invoking *res judicata* as a defense, then the parties' agreement in fact allowed Petitioners to do nothing they could not have done in the absence of such an agreement. By purporting to give content to the parties' claim-splitting agreement while at the same time depriving that agreement of any conceivable legal effect, the Eleventh Circuit's opinion can only bring confusion and uncertainty to the federal law of *res judicata*.

Aside from its internal inconsistency, the court of appeals' decision conflicts with longstanding principles of the law of prior adjudication. Courts and commentators have consistently recognized that the primary purpose underlying the doctrine of *res judicata* "is to protect the defendant from being harassed by repetitive actions based on the same claim. The rule is thus not applicable where the defendant consents, in express words or otherwise, to the splitting of the claim." Restatement (Second) of Judgments § 26, Comment a.[9] As the court of appeals

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[9] While it is true that the doctrine also serves to promote judicial economy, *e.g.*, *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 326 (1979), the fact that a court will not raise issues of preclusion *sua sponte* demonstrates that the purpose of protecting litigants is primary and the purpose of protecting the courts

itself recognized, Merrill Lynch's arbitration agreement is an explicit written consent to the splitting of Petitioners' claims. The court of appeals' refusal to acknowledge the legal consequences of that consent is inconsistent with the Restatement and the countless judicial decisions that follow it.[10]

A recent decision of the Ninth Circuit, *Clark v. Bear Stearns & Co., Inc.*, 966 F.2d 1318 (9th Cir. 1992), reached the opposite result on facts less compelling than those present here. In *Clark*, the plaintiff violated an arbitration agreement similar to the agreement between Petitioners and Merrill Lynch by bringing both arbitrable state-law

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secondary. *See Technograph Printed Circuits, Ltd. v. United States*, 372 F.2d 969, 977 (Ct. Cl. 1967) ("the fact that a party can waive the application of collateral estoppel suggests that the needs of judicial administration are, at best, of subsidiary value"). Here, of course, Merrill Lynch voluntarily gave up the protection of *res judicata* when it signed and required Petitioners to sign an agreement providing for bifurcated proceedings. Moreover, the policy of conserving *judicial* resources has no application at all where the allegedly repetitive proceeding is an arbitration rather than a judicial proceeding, as it is here, since under those circumstances there will be only a single court proceeding in any case. *See Bristol Farmers Market & Auction Co. v. Arlen Realty & Dev. Corp.*, 589 F.2d 1214, 1221 (3d Cir. 1978) (compulsory counterclaim rule does not require defendant to assert arbitrable counterclaim in court: "Where the claim which would be barred if raised in a judicial action is instead pressed as a basis for arbitration, the goal of avoiding multiple litigation is still achieved").

[10] Merrill Lynch has never disputed that section 26 of the Second Restatement is an accurate statement of federal law. *See* Brief of Appellee at 33-34.

claims and non- arbitrable[11] federal securities claims in a single federal lawsuit. Pursuant to the parties' agreement, the district court referred the plaintiff's state-law claims to arbitration. After the arbitration had concluded, the defendants moved for summary judgment on the ground that the plaintiff's federal securities claims were barred by the preclusive effect of the prior arbitration proceeding. The district court denied the defendants' motion, and the Ninth Circuit affirmed. The appeals court rested its decision on the observation that, because the district court had retained jurisdiction over the plaintiff's federal securities claims, the arbitration panel lacked "subject-matter jurisdiction" over those claims and the plaintiff could not have submitted those claims to arbitration.[12] *Id.*

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[11] Like Petitioners' federal securities claims, the plaintiff's federal claims in *Clark* were non-arbitrable as a matter of contract. *See Clark*, 966 F.2d at 1321 n.2 ("There is no dispute here that Bear Stearns' agreement with Clark explicitly reserved from arbitration Clark's federal claims. We enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms").

[12] Although we agree with the result, we respectfully suggest that the Ninth Circuit's reasoning cannot withstand analysis. Arbitration panels do not possess "subject-matter jurisdiction," at least in the ordinary sense, and, although the plaintiff had no prior *obligation* to do so, there was in fact nothing to prevent her from raising all of her claims – federal and state – before the arbitration panel. In our view, the result reached in *Clark* is more appropriately grounded in the proposition that Bear, Stearns consented to bifurcated proceedings both when it executed the agreement and when it moved to compel arbitration. *See Nagle v. Franzese*, 1991 Westlaw 4736, *5 (S.D.N.Y. Jan. 18, 1991) (by moving to compel arbitration of some of plaintiff's claims, defendant consented to splitting of cause of action) (citing Restatement (Second) of Judgments § 26).

at 1321.[13]

Apart from an inconsequential difference in the order of proceedings, the only conceivable distinction between *Clark* and this case is that the plaintiff in *Clark* had to be ordered by a federal district court to comply with her prior agreement to arbitrate, while Petitioners in this case honored their arbitration agreement with Merrill Lynch voluntarily.[14] It is difficult to understand why that distinction should work to Petitioners' disadvantage. Indeed, the Ninth Circuit's reliance on the notion of "jurisdiction" to reach the result it did obscures the fact that this is an easier case than *Clark*. The relevance of

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[13] *See also Williams v. E.F. Hutton & Co., Inc.*, 753 F.2d 117, 119-20 (D.C. Cir. 1985) (prior arbitration did not preclude subsequent court action involving non-arbitrable claims); *Hybert v. Shearson Lehman/American Express Inc.*, 688 F. Supp. 320, 328-29 (N.D. Ill. 1988) (same); *Wing v. J.C. Bradford & Co.*, 678 F. Supp. 622, 627-29 (N.D. Miss. 1987) (same); *Artman v. Prudential-Bache Securities, Inc.*, 670 F. Supp. 769 (S.D. Ohio 1987) (same).

[14] The Eleventh Circuit attempts to distinguish *Clark* on the ground that the arbitration panel lacked "jurisdiction" over the plaintiff's federal claims in *Clark*, while the district court in this case would have had subject-matter jurisdiction to consider Petitioners' arbitrable claims. 985 F.2d at 1070 n.3. The court's distinction is flawed. As we have already noted, arbitration panels do not enjoy "jurisdiction" in the ordinary sense, and the plaintiff in *Clark* was in fact free to submit her federal claims to arbitration. Here, by contrast, Petitioners "could have asserted" their arbitrable claims in court only by breaching their contractual obligation to arbitrate. Neither the lower courts nor Merrill Lynch has ever suggested any reason that a plaintiff who is contractually precluded from raising certain claims in a particular forum should fare any worse than a plaintiff who is precluded from raising the same claims by the jurisdictional limitations of the forum.

jurisdiction to the *res judicata* inquiry lies in the generally accepted notion that a plaintiff who is unable to pursue certain claims or legal theories in his initial action is free to pursue those claims in a second proceeding.[15] Absence of jurisdiction is the most common reason for such an inability. In *Clark*, the Ninth Circuit's jurisdictional remarks notwithstanding, there was nothing which prevented the plaintiff from submitting both her federal securities claims and her state-law claims to the arbitration panel. Here, by contrast, Petitioners were precluded by contract from pursuing their state-law claims in federal court. Thus, if the plaintiff's claims were not barred by *res judicata* in *Clark*, the same result follows *a fortiori* here.

The rule adopted by the Eleventh Circuit will force litigants to breach valid arbitration agreements in order to save their state-law claims from a claim preclusion defense, and will force the federal courts to consider claims which both parties have previously agreed to resolve through arbitration. Under that rule, arbitration agreements like the one used by Merrill Lynch will be without practical effect, for securities plaintiffs will in fact have no choice but to bring all of their claims in a single forum or risk losing half of them. The Eleventh Circuit's rule has nothing apparent to commend it.

The decision of the court of appeals distorts accepted principles of the law of *res judicata* in order to save Merrill Lynch from bifurcated proceedings brought about

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[15] *See Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373, 382 (1985); Restatement (Second) of Judgments § 26(1)(c).

solely because Petitioners complied with an arbitration agreement drafted and imposed on Petitioners by Merrill Lynch. Agreements like the one used by Merrill Lynch are common, within the securities industry and outside it, and their interpretation is a matter of great importance both to the development of the law of *res judicata* and to the efficient administration of the federal courts. Petitioners respectfully suggest that the Court should grant certiorari in order to resolve the important practical and doctrinal issues raised by the Eleventh Circuit's opinion.

CONCLUSION

The lower courts' decisions in this case simultaneously create a nonexistent exception to the Federal Arbitration Act and abolish a long-established exception to the common-law defense of *res judicata*. For the reasons stated, Petitioners respectfully contend that the petition for certiorari should be granted.

Respectfully submitted,

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Supreme Court of the United States

October Term, 1993

FRANK KELLY, MARIA KELLY, JUAN ANTONIO BRANDO, BERTA LASERNA, RAFAEL DAVID POLEO ISAVA, ELLIO CIOCCA, DANIEL PRADO FLORES, MAX GOMEZ, WILLIAM MACKAY, ANTONIA MACKAY, GONZALO BARQUERO, ABRAHAM STEFAN, OSVALDO CORDOVA, RUDY ZEPEDA, THOMAS BOVEE, RICARDO SUCRE, and AGROPECUARIA MILLON, C.A., a foreign corporation,

Petitioners,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware corporation,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

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APPENDIX A

Frank KELLY, Maria Kelly, Juan Antonio Brando, Berta Laserna, Rafael David Poleo Isava, Ellio Ciocca, Daniel Prado Flores, Max Gomez, William Mackay, Antonia Mackay, Gonzalo Barquero, Abraham Stefan, Osvaldo Cordova, Rudy Zepeda, Thomas Bovee, Ricardo Sucre and Agropecuaria Millon, C.A., Plaintiffs-Appellants,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware Corporation, Defendant-Appellee.

Nos. 91-5927, 91-6085.

United States Court of Appeals,
Eleventh Circuit.

March 15, 1993.

Thomas H. Seymour, Harry R. Schafer, Scott E. Perwin, Kenny, Nachwalter, Seymour, Arnold & Critchlow, P.A., Miami, FL, for plaintiffs-appellants.

Bennett Falk, Peter Buscemi, Morgan, Lewis & Bockius, Miami, FL, for defendant-appellee.

Appeals from the United States District Court for the Southern District of Florida.

Before TJOFLAT, Chief Judge, EDMONDSON, Circuit Judge, DYER, Senior Circuit Judge.

PER CURIAM:

This case asks whether the district court properly enjoined arbitration proceedings on the basis of res judicata. We affirm.

Plaintiffs had accounts with defendant Merrill Lynch. In 1987, plaintiffs filed a complaint based on SEC Rules 10b-5 and 10b-16 in district court.[1] After about two years of discovery, plaintiffs dismissed the 10b-16 claim. The court ultimately granted summary judgment to defendant on the remaining Rule 10b-5 claim. We affirmed. *Kelly v. Merrill Lynch*, 948 F.2d 1297 (1991).

Shortly after the district court granted defendant summary judgment, plaintiffs started arbitration of four state common law claims. The state claims alleged essentially the same conduct as the earlier litigation. Defendant moved the district court for a preliminary injunction against the arbitration. Plaintiffs' response included a motion to compel arbitration.

The district court granted the injunction. The district court concluded that 28 U.S.C. § 2283 gives federal courts the power to issue injunctions to protect their own judgments and that res judicata barred the arbitration claim.

I.

We must first decide whether the district court had the power to enjoin arbitration at all. The Anti-Injunction Act, 28 U.S.C. § 2283, says that federal courts can only

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[1] Each plaintiff had previously signed a written agreement with defendant that said:

> Except to the extent that controversies involving claims arising under the federal securities laws may be litigated, any controversy between us arising out of such option transactions or this agreement shall be settled by arbitration . . .

R2-151-12-13.

enjoin state court proceedings in certain cases, including where necessary to protect federal court judgments. Citing this provision, plaintiffs argue federal courts cannot enjoin arbitration because arbitration is not a state court proceeding. *Cf. McDonald v. West Branch,* 466 U.S. 284, 287-88, 104 S.Ct. 1799, 1801-02, 80 L.Ed.2d 302 (1984) (arbitration is not a state court proceeding under 28 U.S.C. § 1738).

The All-Writs Act, 28 U.S.C. § 1651, gives federal courts broad injunctive powers to protect their own judgments. *See, e.g., Kinnear-Weed Corp. v. Humble Oil & Refining Co.,* 441 F.2d 631, 637 (5th Cir.), *cert. denied,* 404 U.S. 941, 92 S.Ct. 285, 30 L.Ed.2d 255 (1971); *Gregis v. Edberg,* 645 F.Supp. 1153, 1157 (W.D.Pa. 1986), *aff'd,* 826 F.2d 1054 (3d Cir.1987). This power includes the authority to enjoin arbitration to prevent re-litigation. *See Tai Ping Insurance Co. v. M/V Warschau,* 731 F.2d 1141, 1144 (5th Cir.1984); *Miller Brewing Co. v. Fort Worth Distr. Co.,* 781 F.2d 494 (5th Cir.1986). We think the Anti-Injunction Act merely carves out an exception to the courts' broad injunctive powers, rather than authorizing an exclusive class of injunctions. The district court had the power to enter an injunction.

II.

The next question is whether the district court properly resolved the res judicata defense, rather than leaving the issue for the arbitrators to resolve. The Federal Arbitration Act, 9 U.S.C. § 2, expresses a policy in favor of arbitration. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.,* 460 U.S. 1, 24, 103 S.Ct. 927, 941, 74 L.Ed.2d 765

(1983). Thus, the general rule for deciding which questions belong to the courts is that, while federal courts can decide if an issue is arbitrable or not, they cannot reach the merits of arbitrable issues. *E.g., Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 218, 105 S.Ct. 1238, 1241, 84 L.Ed.2d 158 (1985); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 402-04, 87 S.Ct. 1801, 1805-06, 18 L.Ed.2d 1270 (1967). And doubts should be resolved in favor of arbitration, even if the result is piecemeal litigation. *See Moses H. Cone*, 460 U.S. at 20, 103 S.Ct. at 939; *Byrd*, 470 U.S. at 218-21, 105 S.Ct. at 1241-43.

Plaintiffs argue that res judicata must be left to arbitration because it is an affirmative defense that goes to the merits of their claims. *See Enterprise Ass'n v. Empire Mech., Inc.*, 1992 WL 84689 *2 (S.D.N.Y. April 9, 1992). We think the better rule is that courts can decide res judicata. *See Miller*, 781 F.2d at 501 (where state court dismissed plaintiff's claims with prejudice, and plaintiff then sought arbitration of claims that could have been brought in state suit, district court properly enjoined arbitration on the basis of res judicata); *see also New York State Ass'n for Retarded Children v. Carey*, 456 F.Supp. 85, 96 (E.D.N.Y.1978) (res judicata is exception to general rule requiring arbitration of issues going to the merits); *City of Rochester v. AFSCME*, 54 A.D.2d 257, 388 N.Y.S.2d 489, 491 (N.Y.App.Div.1976) (same). Courts should not have to stand by while parties re-assert claims that have already been resolved. *See Miller*, 781 F.2d at 497 n. 3 ("res judicata . . . [has] probably done more to prevent useless and wasteful litigation than arbitration ever could."). The issue is not just one of preventing the piecemeal litigation that occurs when parties simultaneously assert claims in

several forums, but of protecting prior judgments. Therefore, the district court properly reached the res judicata issue.

III.

We turn to the merits of the res judicata defense. A party can waive res judicata by consenting to split the claim into two suits. Restatement (Second) of Judgment § 26 cmt. a. The agreement here gave both parties the right to compel arbitration of state law claims, but not federal securities claims, even if both kinds of claims arose from the same events. *See Blue Gray Corps. I & II v. Merrill Lynch,* 921 F.2d 267, 271 (11th Cir.1991). Plaintiffs argue that because defendant essentially agreed to arbitrate some claims but litigate others, defendant waived or should be equitably estopped from asserting res judicata.

We cannot read the agreement as an express or implied waiver of res judicata. The agreement simply allowed plaintiffs to institute two suits based on the same events. Nothing shows that the parties understood – or that defendant led plaintiffs to believe – that the end of first action would not preclude the start of the second.[2] Therefore, defendant was entitled to assert res judicata.

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[2] This lack of misleading conduct on defendant's part distinguishes our case from *Calderon Rosado v. General Elec. Circuit Breakers,* 805 F.2d 1085, 1087 (1st Cir.1986). In *Calderon,* both parties agreed the plaintiff would dismiss her state case and proceed exclusively in federal court, only to have the defendant later plead res judicata in the second claim.

The other cases plaintiffs cite, *Kendall v. Avon Prods.,* 711 F.Supp. 1178, 1182 (S.D.N.Y.1989), and *Imperial Constr. Mgt. Corp. v. Laborers Int'l Local 96,* 729 F.Supp. 1199, 1205-07 (N.D.Ill.

Res judicata bars parties from relitigating issues that were or could have been raised in the first action. *Federated Dep't Stores v. Moitie*, 452 U.S. 394, 398, 101 S.Ct. 2424, 2428, 69 L.Ed.2d 103 (1981). Plaintiffs could have asserted the state claims before the district court, which would have had pendent or diversity jurisdiction over the claims.[3] The uncertainty of whether defendant would move to compel arbitration of the state claims did not justify two proceedings. *Cf. Harper Plastics v. Amoco Chemicals Corp.*, 657 F.2d 939, 946 (7th Cir.1981) (uncertainty of whether court would assert pendent jurisdiction did not

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1990), are also distinguishable. In those cases, the plaintiffs brought two actions simultaneously and the defendants did not object. It is one thing to say that when a defendant acquiesces in simultaneous suits, it impliedly agrees to let both suits proceed to resolution. It is another to say that by simply agreeing in advance of any controversy to litigate state and federal claims that might later arise in different forums, defendant agreed to let plaintiffs initiate one suit, lose, and try again in another forum.

[3] That plaintiffs could have brought all their claims in district court – put differently, the district court had the power to decide all of plaintiffs' claims – distinguishes this case from *Clark v. Bear Stearns & Co.*, 966 F.2d 1318 (9th Cir. 1992). In *Clark*, the plaintiff brought state and federal claims in a single federal suit. Based on a pre-existing arbitration agreement, the district court ordered arbitration of the state claims, but retained jurisdiction over the federal claims. The arbitration panel later dismissed "[a]ll claims."

The Ninth Circuit held that res judicata did not bar the plaintiff from litigating the remaining federal claims in district court. Because the district court retained jurisdiction over the federal claims, the plaintiff could not have asserted them in the arbitration proceeding. Therefore, the arbitral judgment had no effect on the federal claims. *Id.* at 1321.

justify multiple proceedings). The district court properly decided res judicata barred the arbitration.

We review the district court's injunction for abuse of discretion. *See Delta Air Lines, Inc. v. McCoy Restaurants, Inc.*, 708 F.2d 582, 587 (11th Cir.1983); *Tai Ping*, 731 F.2d at 1146. The district court was in the best position to decide whether the arbitration proceedings jeopardized its prior judgment. *See Delta*, 708 F.2d at 586. It did not abuse its discretion by concluding an injunction was necessary.[4]

AFFIRMED.

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[4] In a separate appeal, plaintiffs challenge the costs awarded to defendant. Because the district court neither abused nor failed to use its discretion in awarding costs to defendant, we affirm its award.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

CASE NO. 87-2445-Civ-Nesbitt

FRANK KELLY, MARIA KELLY, et al.,

Plaintiffs,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant.
_____/

ORDER ENJOINING ARBITRATION PROCEEDINGS

THIS CAUSE comes before the court upon the emergency motion of Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") for a preliminary injunction enjoining the Plaintiffs from proceeding in arbitration against Defendant. The Court has considered Defendant's emergency motion, filed October 4, 1991, Plaintiffs' motion to compel arbitration and memorandum in opposition to Defendants' emergency motion, filed October 10, 1991, and Defendant's reply memorandum, filed on October 11, 1991. After due consideration, in accordance with the Court's oral ruling on October 11, 1991, it is

ORDERED AND ADJUDGED that, for the reasons stated below, the motion for preliminary injunction is GRANTED and Plaintiffs are enjoined from proceeding to arbitration against the Defendant until Plaintiffs' appeal from this Court's Order Granting Summary Judgment

dated August 7, 1990, is resolved by the United States Court of Appeals for the Eleventh Circuit.

FACTS

In December 1987, Plaintiffs filed this action alleging violations of § 10(b) of the Securities and Exchange Act of 1934. Plaintiffs specifically alleged in the Complaint that Defendant Merrill Lynch had violated both Rule 10b-5 and Rule 10b-16, but Plaintiffs later voluntarily dismissed their claim under 10(b)(16) with prejudice. No other claims were brought before the Court, and on August 7, 1990, the Court granted summary judgment in favor of the Defendant on the 10(b)(5) claim.

Three weeks after entry of the Final Judgment, Plaintiffs filed a Statement of Claim with the arbitration board of the National Association of Securities Dealers, Inc. ("NASD"). The Amended Statement of Claim indicates that Plaintiffs are now proceeding against Merrill Lynch for their losses that were the subject of this Court's Order granting summary judgment dated August 17, 1990, under a different legal theory. Plaintiffs now argue that Plaintiffs' investments were unsuitable for them in light of their investment experience and that Merrill Lynch should have prevented Plaintiffs from making these investments. The Amended Statement of Claim contains four counts: breach of fiduciary duty, negligence and gross negligence, breach of contract, and negligent misrepresentations and omissions.

ANALYSIS

Defendant argues that this Court must enjoin Plaintiffs from proceeding before NASD because the arbitration is barred by the doctrine of *res judicata* and allowing arbitration to proceed would undermine the final judgment entered by this Court. Defendant argues that the Court has authority to enter this injunction pursuant to Federal Rules of Civil Procedure 65 and 28 U.S.C. §§ 1651 and 2283. Plaintiffs respond by arguing that whether their current claims are barred by the doctrine of *res judicata* is a matter for NASD to decide. Plaintiffs further assert that pursuant to the arbitration agreement, Plaintiffs could not have brought these claims in federal court, and therefore, Plaintiff should be allowed to arbitrate these claims at this time.

It is well established that a district court can issue an injunction under the Anti-Injunction Act, 28 U.S.C. § 2283, "to protect or effectuate its prior judgment. . . ." *Bank of Heflin v. Miles*, 621 F.2d 108, 112 (5th Cir. 1980). Thus, where Plaintiffs attempt to relitigate in another tribunal claims decided by a federal court, the court may properly enjoin those proceedings. *Id.* Under the doctrine of *res judicata*, the parties are prohibited from relitigating a final judgment "as to all claims that were raised or could have been raised [in the federal proceeding]." *Miller Brewing Co. v. Fort Worth Distributing Co.*, 781 F.2d 494, 498 (5th Cir. 1986); *see also Woods Exploration & Producing Company v. Aluminum Company of America*, 438 F.2d 1286, 1315 (5th Cir. 1971) ("*res judicata* would be applicable if plaintiffs were afforded an opportunity to allege the state grounds which constituted the same cause of action"). The prohibition on relitigation includes those state claims

that could have been brought in federal court under the doctrine of pendent jurisdiction, *Woods*, 438 F.2d at 1315, that is, claims which arise out of the same "operative nucleus of fact." *Olmstead v. Amoco Oil Co.*, 725 F.2d 627, 632 (11th Cir. 1984).

A review of the Amended Statement of Claim filed with NASD indicates that Plaintiffs' claims arise from the same "operative nucleus of fact" as their 10(b)(5) claim, which was previously adjudicated by this Court. Moreover, Plaintiffs admit that as "a technical matter" the Court would have enjoyed subject matter jurisdiction over the claims they seek to arbitrate.

The Court finds that under the circumstances of this case, the Court has the authority to enter an injunction to protect its final judgment. Allowing NASD to determine whether the claims are barred by the doctrine of *res judicata* clearly would fail to protect the district court's final judgment. Rather than waiting until this Court decided the merits of their 10(b)(5) claim to raise these additional claims, the Plaintiffs should have brought the pendent claims in the federal action in December of 1987 – regardless of whether Merrill Lynch could have compelled arbitration of these claims. If Plaintiffs had brought all of their claims at that time, this Court could have determined the best manner to adjudicate all of Plaintiffs' claims without the possibility of conflicting decision by various tribunals on the same issues. The Court has determined, however, that it will only enter a preliminary injunction at this stage of the proceedings because Plaintiffs have appealed the final judgment to the Eleventh Circuit. If the judgment is reversed on appeal, it

has no *res judicata* effect. *Woods*, 438 F.2d at 1316. Accordingly, it is further,

ORDERED AND ADJUDGED that the Plaintiffs shall advise the Court when the Eleventh Circuit has disposed of the appeal in this case so that the Court may schedule a hearing on the status of the injunction entered by this Order.

DONE and ORDERED in chambers, Miami, Florida this 17 day of October 1991.

/s/ Lenore C. Nesbitt
LENORE C. NESBITT
UNITED STATES
DISTRICT COURT

cc: counsel of record

APPENDIX C
IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 91-5927, 91-6085

FRANK KELLY, MARIA KELLY, JUAN ANTONIO BRANDO, BERTA LASERNA, RAFAEL DAVID POLEO ISAVA, ELLIO CIOCCA, DANIEL PRADO FLORES, MAX GOMEZ, WILLIAM MACKAY, ANTONIA MACKAY, GONZALO BARQUERO, ABRAHAM STEFAN, OSVALDO CORDOVA, RUDY ZEPEDA, THOMAS BOVEE, RICARDO SUCRE, AGROPECUARIA MILLON, C.A.,

Plaintiffs-Appellants,

versus

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware Corporation,

Defendant-Appellee.

On Appeal from the United States District Court for the Southern District of Florida

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ON PETITION(S) FOR REHEARING AND SUGGESTION(S) OF REHEARING EN BANC

(Filed June 29, 1993)

Before: TJOFLAT, Chief Judge, EDMONDSON, Circuit Judge and DYER, Senior Circuit Judge.

PER CURIAM:

(X) The Petition(s) for Rehearing are DENIED and no member of this panel nor other Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 35-5), the Suggestion(s) of Rehearing En Banc are DENIED.

( ) The Petition(s) for Rehearing are DENIED and the Court having been polled at the request of one of the members of the Court and a majority of the Circuit Judges who are in regular active service not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 35-5), the Suggestion(s) of Rehearing En Banc are also DENIED.

( ) A member of the Court in active service having requested a poll on the reconsideration of this cause en banc, and a majority of the judges in active service not having voted in favor of it, Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ J.L. Edmondson
UNITED STATES CIRCUIT JUDGE

APPENDIX D

ARBITRATION

§ 1. "Maritime transactions" and "commerce" defined; exceptions to operation of title

"Maritime transactions", as herein defined, means charter parties, bills of lading of water carriers, agreements relating to wharfage, supplies furnished vessels or repairs to vessels, collisions, or any other matters in foreign commerce which, if the subject of controversy, would be embraced within admiralty jurisdiction; "commerce", as herein defined, means commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation, but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.

July 30, 1947, c. 392, 61 Stat. 670.

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§ 2. Validity, irrevocability, and enforcement of agreements to arbitrate

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out

of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

July 30, 1947, c. 392, 61 Stat. 670.

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§ 3. Stay of proceedings where issue therein referable to arbitration

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

July 30, 1947, c. 392, 61 Stat. 670.

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§ 4. Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by the Federal Rules of Civil Procedure. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of

application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

July 30, 1947, c. 392, 61 Stat. 671; Sept. 3, 1954, c. 1263, § 19, 68 Stat. 1233.

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§ 5. Appointment of arbitrators or umpire

If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or an umpire, such method shall be followed; but if no method be provided therein, or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason there shall be a lapse in the naming of an arbitrator or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator or arbitrators or umpire, as the case may require, who shall act under the said agreement with the same force and effect as if he or they had been

specifically named therein; and unless otherwise provided in the agreement the arbitration shall be by a single arbitrator.

July 30, 1947, c. 392, 61 Stat. 671.

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§ 6. Application heard as motion

Any application to the court hereunder shall be made and heard in the manner provided by law for the making and hearing of motions, except as otherwise herein expressly provided.

July 30, 1947, c. 392, 61 Stat. 671.

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§ 7. Witnesses before arbitrators; fees; compelling attendance

The arbitrators selected either as prescribed in this title or otherwise, or a majority of them, may summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case. The fees for such attendance shall be the same as the fees of witnesses before masters of the United States courts. Said summons shall issue in the name of the arbitrator or arbitrators, or a majority of them, and shall be signed by the arbitrators,

or a majority of them, and shall be directed to the said person and shall be served in the same manner as subpoenas to appear and testify before the court; if any person or persons so summoned to testify shall refuse or neglect to obey said summons, upon petition the United States district court for the district in which such arbitrators, or a majority of them, are sitting may compel the attendance of such person or persons before said arbitrator or arbitrators, or punish said person or persons for contempt in the same manner provided by law for securing the attendance of witnesses or their punishment for neglect or refusal to attend in the courts of the United States.

July 30, 1947, c. 392, 61 Stat. 672; Oct. 31, 1951, c. 655, § 14, 65 Stat. 715.

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§ 8. Proceedings begun by libel in admiralty and seizure of vessel or property

If the basis of jurisdiction be a cause of action otherwise justiciable in admiralty, then, notwithstanding anything herein to the contrary, the party claiming to be aggrieved may begin his proceeding hereunder by libel and seizure of the vessel or other property of the other party according to the usual course of admiralty proceedings, and the court shall then have jurisdiction to direct the parties to proceed with the arbitration and shall retain jurisdiction to enter its decree upon the award.

July 30, 1947, c. 392, 61 Stat. 672.

§ 9. Award of arbitrators; confirmation; jurisdiction; procedure

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title. If no court is specified in the agreement of the parties, then such application may be made to the United States court in and for the district within which such award was made. Notice of the application shall be served upon the adverse party, and thereupon the court shall have jurisdiction of such party as though he had appeared generally in the proceeding. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a nonresident, then the notice of the application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court.

July 30, 1947, c. 392, 61 Stat. 672.

§ 10. Same; vacation; grounds; rehearing

(a) If any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration –

(1) Where the award was procured by corruption, fraud, or undue means.

(2) Where there was evident partiality or corruption in the arbitrators, or either of them.

(3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

(5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

(b) The United States district court for the district wherein an award was made that was issued pursuant to section 580 of title 5 may make an order vacating the award upon the application of a person, other than a party to the arbitration, who is adversely affected or aggrieved by the award, if the use of arbitration or the award is clearly inconsistent with the factors set forth in section 572 of title 5.

(As amended Nov. 15, 1990, Pub.L. 101-552, § 5, 104 Stat. 2745; Aug. 26, 1992, Pub.L. 102-354, § 5(b)(4), 106 Stat. 946.)

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§ 11. Same; modification or correction; grounds; order

In either of the following cases the United States court in and for the district wherein the award was made may make an order modifying or correcting the award upon the application of any party to the arbitration –

(a) Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.

(b) Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted.

(c) Where the award is imperfect in matter of form not affecting the merits of the controversy.

The order may modify and correct the award, so as to effect the intent thereof and promote justice between the parties.

July 30, 1947, c. 392, 61 Stat. 673.

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§ 12. Notice of motions to vacate or modify; service; stay of proceedings

Notice of a motion to vacate, modify, or correct an award must be served upon the adverse party or his attorney within three months after the award is filed or delivered. If the adverse party is a resident of the district within which the award was made, such service shall be made upon the adverse party or his attorney as prescribed by law for service of notice of motion in an action in the same court. If the adverse party shall be a nonresident then the notice of the application shall be served by the marshal of any district within which the adverse party may be found in like manner as other process of the court. For the purpose of the motion any judge who might make an order to stay the proceedings in an action brought in the same court may make an order, to be served with the notice of motion, staying the proceedings of the adverse party to enforce the award.

July 30, 1947, c. 392, 61 Stat. 673.

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§ 13. Papers filed with order on motions; judgment; docketing; force and effect; enforcement

The party moving for an order confirming, modifying, or correcting an award shall, at the time such order is filed with the clerk for the entry of judgment thereon, also file the following papers with the clerk:

(a) The agreement; the selection or appointment, if any, of an additional arbitrator or umpire; and each written extension of the time, if any, within which to make the award.

(b) The award.

(c) Each notice, affidavit, or other paper used upon an application to confirm, modify, or correct the award, and a copy of each order of the court upon such an application.

The judgment shall be docketed as if it was rendered in an action.

The judgment so entered shall have the some force and effect, in all respects, as, and be subject to all the provisions of law relating to, a judgment in an action; and it may be enforced as if it had been rendered in an action in the court in which it is entered.

July 30, 1947, c. 392, 61 Stat. 673.

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§ 14. Contracts not affected

This title shall not apply to contracts made prior to January 1, 1926.

July 30, 1947, c. 392, 61 Stat. 673.

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§ 15. Inapplicability of the Act of State doctrine

Enforcement of arbitral agreements, confirmation of arbitral awards, and execution upon judgments based on orders confirming such awards shall not be refused on the basis of the Act of State doctrine.

(Added Pub.L. 100-669, § 1, Nov. 16, 1988, 102 Stat. 3969.)

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§ 16. Appeals

(a) An appeal may be taken from –

(1) an order –

(A) refusing a stay of an action under section 3 of this title,

(B) denying a petition under section 4 of this title to order arbitration to proceed,

(C) denying an application under section 206 of this title to compel arbitration,

(D) confirming or denying confirmation of an award or partial award, or

(E) modifying, correcting, or vacating an award;

(2) and interlocutory order granting, continuing, or modifying an injunction against an arbitration that is subject to this title; or

(3) a final decision with respect to an arbitration that is subject to this title.

(b) Except as otherwise provided in section 1292(b) of title 28, an appeal may not be taken from an interlocutory order –

(1) granting a stay of any action under section 3 of this title;

(2) directing arbitration to proceed under section 4 of this title;

(3) compelling arbitration under section 206 of this title; or

(4) refusing to enjoin an arbitration that is subject to this title.

(Added Pub.L. 100-702, Title X, § 1019(a), Nov. 19, 1988, 102 Stat. 4671, § 15, renumbered Pub.L. 101-650, Title III, § 325(a)(1), Dec. 1, 1990, Stat. 5120.)

APPENDIX E

§ 26. Exceptions to the General Rule Concerning Splitting

(1) When any of the following circumstances exists, the general rule of § 24 does not apply to extinguish the claim, and part or all of the claim subsists as a possible basis for a second action by the plaintiff against the defendant:

(a) The parties have agreed in terms or in effect that the plaintiff may split his claim, or the defendant has acquiesced therein; or

(b) The court in the first action has expressly reserved the plaintiff's right to maintain the second action; or

(c) The plaintiff was unable to rely on a certain theory of the case or to seek a certain remedy or form of relief in the first action because of the limitations on the subject matter jurisdiction of the courts or restrictions on their authority to entertain multiple theories or demands for multiple remedies or forms of relief in a single action, and the plaintiff desires in the second action to rely on that theory or to seek that remedy or form of relief; or

(d) The judgment in the first action was plainly inconsistent with the fair and equitable implementation of a statutory or constitutional scheme, or it is the sense of the scheme that the plaintiff should be permitted to split his claim; or

(e) For reasons of substantive policy in a case involving a continuing or recurrent wrong, the plaintiff is given an option to sue

once for the total harm, both past and prospective, or to sue from time to time for the damages incurred to the date of suit, and chooses the latter course; or

(f) It is clearly and convincingly shown that the policies favoring preclusion of a second action are overcome for an extraordinary reason, such as the apparent invalidity of a continuing restraint or condition having a vital relation to personal liberty or the failure of the prior litigation to yield a coherent disposition of the controversy.

(2) In any case described in (f) of Subsection (1), the plaintiff is required to follow the procedure set forth in §§ 78-82.

Supreme Court, U.S.
FILED
NOV 17 1993
CLERK

No. 93-486

In the Supreme Court of the United States

OCTOBER TERM, 1993

FRANK KELLY, ET AL., PETITIONERS

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

This case involves the res judicata effect of a district court judgment against petitioners and in favor of respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"). That judgment was affirmed by the court of appeals, and petitioners did not seek review in this Court. Soon after the district court entered its judgment, petitioners began an arbitration against Merrill Lynch. The arbitration arose from the same facts as the earlier district court litigation, but petitioners asserted a theory of liability diametrically opposite from the one that they had pursued unsuccessfully in the district court. Merrill Lynch asked the district court to enforce its own judgment and enjoin the arbitration on res judicata grounds. The district court entered the requested injunction, and the court of appeals again affirmed. The questions presented are:

1. Whether the district court was entitled to consider and decide Merrill Lynch's claim of res judicata.

2. Whether the district court properly ruled that petitioners' arbitration is barred by res judicata.

STATEMENT UNDER RULE 29.1

In accordance with Rule 29.1 of the Rules of this Court, respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. states that its parent company is Merrill Lynch & Co., Inc. and that it has the following subsidiaries (other than wholly owned subsidiaries):

Merrill Lynch Life Agency, Inc. (Ohio)
Merrill Lynch Life Agency, Inc. (Oklahoma)
Merrill Lynch Life Agency, Ltd. (Mississippi)
Merrill Lynch-Nomura Management Company, Inc.
ML Life Agency Inc.
Wagner Stott Clearing Corp.

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In the Supreme Court of the United States

OCTOBER TERM, 1993

No. 93-486

FRANK KELLY, ET AL., PETITIONERS

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

Respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), by its undersigned counsel, submits this brief in opposition to the petition for a writ of certiorari in this case.

STATEMENT OF THE CASE

A. The Trading Activity That Gave Rise To Petitioners' Claims

Petitioner Frank Kelly is a former Merrill Lynch account executive. The other petitioners are Kelly's wife and 15 of Kelly's former customers, including one corporate investor.[1] During the period from late 1982

[1] Many of the relevant facts are set forth in the district court's opinion granting summary judgment for Merrill Lynch. That opinion, which is unreported, was not reproduced in the appendix to the petition. It is reprinted as an appendix to this brief.

through late 1986, all of the petitioners, including Kelly and his wife, opened individual or joint trading accounts at the Merrill Lynch office in Coral Gables, Florida, where Kelly worked.

Petitioner Kelly, by his own admission an experienced and knowledgeable investor who had been employed as a securities broker with both Dean Witter and PaineWebber before working for Merrill Lynch, devised an investment strategy that petitioners used in trading stock index options. The strategy involved the short sale of options based on the Standard & Poor's 100 stock index. These options, known by the trading symbol "OEX", are traded on the Chicago Board of Options Exchange. Kelly's strategy generally consisted of the simultaneous sale of OEX "calls" (*i.e.*, options to buy) and OEX "puts" (*i.e.*, options to sell). Petitioners' sales of these options were "short" sales because petitioners sold options that they did not own at the time of sale. Petitioners could earn a profit if the options expired unexercised (thus enabling petitioners to retain the full price they received when they sold the options), or if the price of the options declined (thus enabling petitioners to cover their "short" positions and retain the difference between the price at which they had sold the options and the price at which they subsequently purchased them).

Petitioners' strategy could be successful only in periods of relative market stability. As the district court observed (App. 3a), in periods of market volatility, "this kind of trading results in losses." If the market moves sharply up, the prices of "calls" increase significantly; if the market moves sharply down, the prices of "puts" increase significantly. In either event, those increases can produce substantial losses for short sellers, losses that are by no means limited by the amount of the original price at which an option was sold.

When petitioners opened their accounts, they received all of the required disclosure documents, including a brochure entitled "Characteristics and Risks of Standardized Options," which detailed in plain language the operation of standardized option markets. Petitioners also signed a "Standard Option Agreement" and a "Customer Agreement". These documents clearly spelled out the risks of options trading. In addition, Kelly himself advised each petitioner on the trading of index options. Against the background of these disclosures, each petitioner individually chose to engage in the trading strategy masterminded by Kelly.

In early 1987, "the stock market moved dramatically against the option positions held by [petitioners]." App. 3a. Accordingly, Merrill Lynch exercised its right to require petitioners to increase the amount of money on deposit in petitioners' accounts to ensure petitioners' ability to perform their obligations with respect to the options sold short. Some petitioners initially complied with Merrill Lynch's new requirements, but most did not. As the market continued to move against petitioners' positions, Merrill Lynch bought the options needed to close petitioners' short positions and charged petitioners' accounts for the purchase price of those options. As a result, petitioners realized the losses that they had suffered due to the adverse movement of the market. App. 3a-4a, 5a n.4.

B. Petitioners' Federal Lawsuit

In December 1987, petitioners sued Merrill Lynch in the United States District Court for the Southern District of Florida, alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rules 10b-5 and 10b-16 promulgated under that statute, 17 C.F.R. § 240.10b-5 and § 240.10b-16. Petitioners charged Merrill Lynch with fraud in connection with the purchase or sale of securities, in violation of Rule 10b-5, and with inadequate disclosure of credit terms and information

regarding the extension of credit in securities transactions, in violation of Rule 10b-16. The thrust of both claims was that Merrill Lynch had improperly raised the collateral requirements for petitioners' short sales of stock index options and that, as a result, petitioners' existing positions were prematurely liquidated and petitioners were precluded from continuing with their trading strategy—a strategy that, according to petitioners' allegations, eventually would have produced substantial profits.

After more than two years of litigation and extensive discovery, Merrill Lynch moved for summary judgment on both counts of the complaint. With respect to the Rule 10b-16 count, Merrill Lynch explained that petitioners' options trading did not involve any extensions of credit, that in fact options are not permitted to be purchased or sold on credit, and that therefore the rule simply did not apply to the transactions about which petitioners were complaining. Petitioners then decided to "narrow the focus" of their case by moving to dismiss their Rule 10b-16 claim without prejudice. Petitioners informed the district court that they could "obtain all the relief necessary to make them whole through their 10b-5 claim." App. 5a n.3. The district court correctly ruled that the Rule 10b-16 count should be dismissed *with* prejudice, and petitioners did not challenge that decision.

Turning to the Rule 10b-5 count, Merrill Lynch argued (1) that Merrill Lynch did not make any misstatement or omission of material fact; (2) that Merrill Lynch did not act with scienter; and (3) that Merrill Lynch did not proximately cause any of the losses suffered by appellants. The district court granted summary judgment for Merrill Lynch on the grounds that petitioners had not adduced sufficient evidence to create any genuine issue of material fact with respect to the scienter and loss causation elements of the 10b-5 claim. App. 5a-16a. The court of appeals summarily affirmed. 948 F.2d 1297 (1991).

C. Petitioners' Claims In Arbitration

In August 1990, three weeks after the district court granted summary judgment, and nearly three and one half years after the latest of the operative events, petitioners began the controversy all over again by initiating an arbitration against Merrill Lynch before the National Association of Securities Dealers, Inc. ("NASD"). Having failed in their effort to blame Merrill Lynch for terminating their trading strategy, petitioners abandoned that theory and switched to one looking in precisely the opposite direction.

Suddenly, the trading strategy that, according to petitioners' submissions in the district court, would have led inexorably to profits became a strategy that was flawed from the outset. Petitioners contended that their short sales of index options were unsuitable investments in view of petitioners' investment objectives, investment experience, and net worth. They also alleged that Merrill Lynch failed to supervise adequately the trading in petitioners' accounts and the activities of petitioner Kelly. In addition, petitioners complained about Merrill Lynch's alleged failure to disclose adequately the risks of petitioners' trading strategy and to subject petitioners' trading to the firm's customary approval process. Based on these allegations, petitioners asserted state law claims of breach of fiduciary duty, negligence, breach of contract, and negligent misrepresentation.

Petitioners sought in the arbitration to recover the very losses that they had tried unsuccessfully to recoup in the federal litigation. Their claims in arbitration, however, marked an abrupt about-face from the theories that petitioners had attempted unsuccessfully to foist on the district court during nearly three years of litigation (and that petitioners continued to pursue in the court of appeals even after the arbitration was under way). Petitioners withheld these new claims from the district court, but it was not for lack of the legal ability to raise those

claims in the litigation. Indeed, petitioners themselves conceded in the district court that that court "would have enjoyed subject-matter jurisdiction as a technical matter . . . ." R2-153, at 9 (Petitioners' Motion to Compel Arbitration). Rather, petitioners refrained from pursuing their common law claims in the litigation for the obvious practical reason that the gross inconsistencies in their position would have done irreparable damage to their credibility before the district court.

D. Merrill Lynch's Request For An Injunction On The Ground Of Res Judicata

Merrill Lynch undertook discovery in the arbitration, largely for the purpose of confirming what seemed apparent from petitioners' Statements of Claim, namely, that petitioners were simply trying to assert new claims based on the same facts that had already been litigated. Once the pre-hearing preparation had been completed, and petitioners had failed to identify any new facts on which they were seeking to rely, Merrill Lynch returned to the district court and moved for an order enforcing the district court's judgment and precluding petitioners from proceeding with the arbitration. Merrill Lynch explained that "[b]ecause the claims raised by appellants in the arbitration arose not only from the same nucleus of operative facts, but the *identical set of facts*, and could have been raised in this action, they are barred by *res judicata*." R2-151, at 2 (emphasis in original).

Petitioners opposed Merrill Lynch's motion and moved to compel arbitration. Petitioners first argued that the res judicata claim could be decided only in the arbitration and that, in any event, the district court lacked authority to enjoin petitioners from proceeding with the arbitration. As to the merits of the res judicata claim, petitioners relied primarily on the arbitration clause in their customer agreements with Merrill Lynch, contending that this constituted a waiver of any right to assert the preclusive effect of the district court's judgment. Although conceding that

the district court would have had subject-matter jurisdiction over petitioners' pendent state law claims, petitioners also attempted to argue that their arbitration claims "could not have been raised in the prior federal-court action," because Merrill Lynch could have sought to compel arbitration of those claims. R2-153, at 2-3.

E. The Decisions Below

The district court rejected petitioners' arguments and entered an order enjoining petitioners from proceeding with their arbitration. Pet. App. B-1 to B-5. The court explained:

> where Plaintiffs attempt to relitigate in another tribunal claims decided by a federal court, the court may properly enjoin those proceedings. Under the doctrine of *res judicata*, the parties are prohibited from relitigating a final judgment "as to all claims that were raised or could have been raised [in the federal proceeding]." . . . The prohibition on relitigation includes those state claims that could have been brought in federal court under the doctrine of pendent jurisdiction, that is, claims which arise out of the same "operative nucleus of fact."
>
> . . . Plaintiffs' claims arise from the same "operative nucleus of fact" as their 10(b)(5) claim, which was previously adjudicated by this Court. . . .
>
> . . . Allowing NASD to determine whether the claims are barred by the doctrine of *res judicata* clearly would fail to protect the district court's final judgment. Rather than waiting until this Court decided the merits of their 10(b)(5) claim to raise these additional claims, the Plaintiffs should have brought the pendent claims in the federal action in December of 1987—regardless of whether Merrill Lynch could have compelled arbitration of these claims. If Plaintiffs had brought all of their claims at that time, this Court could have determined the best manner to adjudicate all of Plaintiffs' claims

> without the possibility of conflicting decision by various tribunals on the same issues.

Pet. App. B-3 to B-4 (citations omitted; brackets in original).

The court of appeals affirmed. Pet. App. A-1 to A-7. The court rejected petitioners' argument that the res judicata issue could be decided *only* in the arbitration. The court did not seek to preclude arbitrators from addressing res judicata claims, but it did insist that courts must be permitted to protect their own judgments, even in the face of a demand for arbitration. In the court's words, "the better rule is that courts can decide res judicata. . . . Courts should not have to stand by while parties re-assert claims that have already been resolved. . . . The issue is not just one of preventing the piecemeal litigation that occurs when parties simultaneously assert claims in several forums, but of protecting prior judgments." Pet. App. A-4 to A-5.

Turning to the merits, the court of appeals sustained the district court's injunction. The court rejected petitioners' attempt to characterize the arbitration clause in the parties' customer agreements as a waiver of res judicata or a blanket authorization to split claims. The court stated (Pet. App. A-5):

> We cannot read the agreement as an express or implied waiver of res judicata. The agreement simply allowed [petitioners] to institute two suits based on the same events. Nothing shows that the parties understood—or that [Merrill Lynch] led [petitioners] to believe—that the end of the first action would not preclude the start of the second.

Because petitioners could have raised all of their claims in the district court, and the district court would have had pendent or diversity jurisdiction over all of those claims, the court of appeals upheld the district court's injunction. The court correctly ruled that speculation about whether Merrill Lynch could have or would have

sought to compel arbitration of the state law claims is not relevant to the res judicata determination. Pet. App. A-6 to A-7.

ARGUMENT

The court of appeals' decision is correct, and further review is not warranted. Despite petitioners' hyperbole, no unresolved or controversial question of federal law is presented here. Federal district courts have the unquestioned authority to protect and enforce their own judgments, and nothing in the Federal Arbitration Act was intended to remove or restrict that authority. Similarly, the arbitration clause in the parties' customer agreements did not address, much less waive, the res judicata protection. Rather, it simply enabled either party to compel arbitration of state law claims. It said nothing about arbitrations not commenced until after an adverse federal judgment on the same facts. There is no conflict among the circuits with regard to any of the issues that petitioners seek to present, no conflict with general federal policy, and no conflict with any decision of this Court.

Moreover, the contractual arbitration clause that has given rise to the present dispute is a remnant of a bygone era during which, as a result of this Court's decision in *Wilko v. Swan*, 346 U.S. 427 (1953), agreements to arbitrate under the federal securities laws were not enforceable. Arbitration clauses, like the one at issue here, therefore acknowledged that securities law claims could be litigated. Now, however, *Wilko* has been overruled in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), and most customer agreements between brokerage firms and investors provide for arbitration of all claims, including claims under the securities laws. Accordingly, the situation presented here is unlikely to recur, and the petition for review should be denied.

I. THE DISTRICT COURT WAS ENTITLED TO ENFORCE ITS OWN JUDGMENT AND ADDRESS MERRILL LYNCH'S CLAIM OF RES JUDICATA

Petitioners' characterization of the lower courts' rulings is inaccurate. Neither the district court nor the court of appeals "carved out a broad and unprecedented exception" (Pet. 5) to the important federal policies embodied in the Federal Arbitration Act, 9 U.S.C. §§ 1 *et seq.* Rather, the court of appeals, in affirming the district court's ruling, expressly recognized that courts ordinarily should not reach the merits of arbitrable issues. Pet. App. A-4 (citing *Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 218 (1985); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967)). The courts below also recognized, however, what petitioners would prefer to ignore, namely, that federal courts have well-established authority to enforce their own judgments and to determine the res judicata effect of prior decisions.

None of the authorities on which petitioners rely deals with a claim of res judicata or with a district court's authority to enforce its prior judgments. Petitioners' arguments simply disregard the significance of the district court's final judgment in favor of Merrill Lynch. The Federal Arbitration Act does not address the question of how a claim of res judicata based on a district court judgment should be resolved; certainly the Act does not purport to impose limits that would not otherwise exist on the authority of district courts to effectuate their decisions. Likewise, the cases on which petitioners rely simply do not address a district court's authority *vel non* to enforce its own judgments by refusing to permit a party from pursuing in another forum claims that were or could have been raised in a case that the district court has already decided.[2]

---

[2] Contrary to petitioners' assertion (Pet. 7 n.5), the unreported district court decision cited by the court of appeals did not involve a situation like that presented here. Instead, *Enterprise Ass'n*

Prima Paint Corp., for example, is inapposite precisely because it does not involve the preclusive effect of a prior district court judgment. The case held that a defense of "fraud in the inducement" as to the contract as a whole (not merely the arbitration agreement) is an issue on the merits for the arbitrators to decide. 388 U.S. at 404. Here, however, Merrill Lynch did not ask the district court to evaluate the underlying merits of the parties' conduct; it sought merely to give effect to the court's own final judgment, *separately* from and *independently* of the arbitration.

Similarly, petitioners' reliance on *Dean Witter Reynolds v. Byrd* is misplaced. *Byrd* held that arbitrable and non-arbitrable claims may proceed *simultaneously* in an arbitral forum and a court. *Byrd* did *not* hold that an arbitration may proceed even *after* there has been a final judgment entered in the court action. To the contrary, this Court expressly acknowledged that a prior decision in one forum could have a preclusive effect in the other, and it left to the lower federal courts the task of determining, in the first instance, to what extent and under what circumstances arbitration decisions should be given preclusive effect in litigation. 470 U.S. at 222-23. The Court never suggested that the federal policy favoring arbitration somehow bars federal district courts from enforcing their own judgments or that the courts are not the appropriate entities to determine the preclusive effect of their own decisions.

Metal Trades Branch Local Union 638 v. Empire Mechanical, Inc., 122 Lab. Cas. ¶ 10,284, 1992 Westlaw 84689 (S.D.N.Y. 1992), involved a defendant corporation that unsuccessfully asserted a res judicata defense during the course of an arbitration and then tried to reassert that defense when the arbitration claimant sought judicial enforcement of the arbitration award. The district court refused to reconsider a defense already rejected by the arbitration panel. Such a defense, the court said, is "not for the Court on a petition to confirm the award." Slip op. at 2-3.

General discussions about the extent to which federal law encourages arbitration are no substitute for precedent dealing with the discrete issue presented here. That issue is whether a district court, having fully adjudicated a controversy between two parties through protracted litigation extending over a period of years, must sit idly by while the unsuccessful party attempts, in derogation of the district court's judgment, to relitigate its case in another forum on the basis of a new theory inconsistent with the one previously litigated. The courts below correctly held that the answer to this question is negative.

Petitioners inaccurately depict the court of appeals' ruling as "ignor[ing] fifty years of federal precedent." Pet. 8. In fact, federal courts have long exercised their inherent power to determine the res judicata effect of prior federal court rulings notwithstanding parties' agreements to submit the merits of their disputes to arbitration.[3] Perhaps the leading decision is *Miller Brewing Co.*

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[3] *See, e.g., Telephone Workers Union, Local 827 v. New Jersey Bell Tel. Co.*, 584 F.2d 31, 33 (3d Cir. 1978) ("When a federal court is presented with the contention that a prior federal judgment determined issues now sought to be relitigated in an arbitral forum [the court] must first determine the effect of the judgment. . . . The federal policy favoring [arbitration] clauses . . . does not come into play until the court first determines whether prior completed litigation has already finally determined all issues."); *Sprague & Rhodes Commodity Corp. v. Instituto Mexicano Del Cafe*, 566 F.2d 861, 863 (2d Cir. 1977) (instructing district court in appropriate circumstances to determine *res judicata* effect of a foreign judgment on a petition to compel arbitration); *Clemens v. Central R.R. Co. of New Jersey*, 399 F.2d 825 (3d Cir. 1968) (holding plaintiffs' claims barred by *res judicata* and not properly submitted to arbitration), *cert. denied*, 393 U.S. 1023 (1969); *American Train Dispatchers Assoc. v. Burlington N. R.R. Co.*, 784 F. Supp. 899, 903 (D.D.C. 1992) ("[C]ourts have the right of plenary review when asked to determine the preclusive effects of a federal judgment on relitigation of the same issues in an arbitral forum. If we have finally decided something as a matter of law, an arbitral panel may not completely disregard that conclusion."); *Fremont Cake & Meal Co. v. Wilson & Co., Inc.*, 183 F.2d 57 (8th Cir. 1950) (holding that district court properly determined that, based on

v. Fort Worth Distributing Co., 781 F.2d 494 (5th Cir. 1986), which petitioners relegate to a footnote in this Court, as they did in the court of appeals. *See* Pet. 7-8 n.5. *Miller Brewing* held that a res judicata defense constitutes "good ground for enjoining arbitration proceedings," and that "parties should be barred from seeking relief from arbitration panels when, under the doctrine of *res judicata*, they would be barred from seeking relief in the courts." *Id.* at 498, 499. The court of appeals explicitly rejected the very kind of argument made by petitioners based on federal law's general encouragement of arbitration:

> We are mindful of the admonition . . . that arbitration is ordinarily preferable to litigation, but to allow arbitration on top of the protracted litigation in this case would be to add insult to injury. The doctrine of res judicata . . . [has] probably done more to prevent useless and wasteful litigation than arbitration ever could.

Id. at 497 n.3. Although res judicata provides what is probably the strongest justification for a judicial refusal to defer indiscriminately to arbitration, petitioners are also misinformed in their contention that the court of appeals has singled out the claim of res judicata as the sole bar to arbitration that can ever be considered by a

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prior adjudication, there was no controversy to arbitrate and properly dismissed with prejudice the action to compel arbitration); *Burmah Oil Tankers, Ltd. v. Trisun Tankers, Ltd.*, 687 F. Supp. 897, 899 (S.D.N.Y. 1988) ("A federal court may enjoin state court actions that threaten to relitigate and impair a federal judgment. It would be incongruous if the federal courts could not exercise the same power to protect judgments against later arbitration proceedings."); *National Shipping & Trading Corp. v. Buck Shipping Int'l Ltd.*, No. 81 Civ. 3818-CSH (S.D.N.Y. April 3, 1985) ("an asserted *res judicata* bar is appropriate for consideration by the court in a motion to compel (or to stay) arbitration"); *Ank Shipping Co. v. Seychelles Nat'l Commodity Co., Ltd.*, 596 F. Supp. 1455 (S.D.N.Y. 1984) (holding petition to compel arbitration barred by res judicata).

district court. Federal courts have addressed a number of other arguments that, if found meritorious, similarly would preclude the need for an arbitration to address the merits of the dispute.[4]

The court of appeals therefore was correct in concluding that "the better rule is that courts can decide res judicata." Pet. App. A-4. The federal policy favoring arbitration is not implicated until the district court has had an opportunity to decide the issue of whether or not all claims have already been resolved by prior litigation.

II. THE COURTS BELOW CORRECTLY CONCLUDED THAT PETITIONERS' ARBITRATION IS BARRED BY RES JUDICATA

Petitioners do not take issue with the district court's finding that their state law claims arise from the same "operative nucleus of fact" as the 10(b)(5) claim that was previously adjudicated by the district court. Pet.

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[4] *See, e.g., National R.R. Passenger Corp. v. Boston and Maine Corp.*, 850 F.2d 756 (D.C. Cir. 1988) (holding that the court rather than the arbitrator properly considered the defense that the duty to arbitrate did not survive the termination date of the agreement); *Local Union No. 4-243, Oil Workers Int'l Union v. Mobil Oil Corp.*, 558 F.2d 233 (5th Cir. 1977) (holding that the district court properly considered the background and setting of the dispute in addressing the defense that there was no remaining dispute for the arbitrators to arbitrate); *International Ladies' Garment Workers' Union v. Ashland Indus., Inc.*, 488 F.2d 641 (5th Cir.), *cert. denied*, 419 U.S. 840 (1974) (holding that, in labor dispute, district court rather than arbitrator should determine whether, in arbitration subsequent to district court ruling on the same facts, an inconsistent defense should be barred); *Virginia Carolina Tools, Inc. v. International Tool Supply, Inc.*, 793 F. Supp. 664 (W.D.N.C. 1992), *aff'd*, 984 F.2d 113 (4th Cir.), *cert. denied*, 113 S. Ct. 2930 (1993) (holding that the court rather than the arbitrators properly considered the defense that a contract had not been extended beyond its expiration date by the parties); *Liberty Univ., Inc. v. Kemper Sec. Group, Inc.*, 758 F. Supp. 1148 (W.D. Va. 1991) (holding that the court rather than the arbitrator properly considered the defense that the duty to arbitrate did not survive the termination date of the agreement).

App. B-4. Nor do petitioners deny that, as they themselves conceded in the district court, that court would have had jurisdiction over the claims that petitioners later sought to arbitrate. Pet. App. B-4; *see also* Pet. App. A-6. Petitioners were thus able to bring all of their claims in the district court, but they failed to do so. When the district court then entered a final judgment on the claims that *were* litigated, the pendent state law claims were lost forever.

As this Court held in *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981), "[a] final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were *or could have been raised* in that action." *Id.* at 398 (emphasis added). The Court in *Federated Department Stores* reiterated the importance of res judicata: " '[the] doctrine of *res judicata* is not a mere matter of practice or procedure inherited from a more technical time than ours. *It is a rule of fundamental and substantial justice . . . which should be cordially regarded and enforced by the courts . . . .*' " *Id.* at 401, quoting *Hart Steel Co. v. Railroad Supply Co.*, 244 U.S. 294, 299 (1917) (brackets in original) (emphasis added). *See also Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948); Currie, *Res Judicata: The Neglected Defense*, 45 U. Chi. L. Rev. 317, 325 (1978) ("to allow a party to advance arguments in a second proceeding that he could have made in a prior proceeding but did not . . . imposes unnecessary costs on both opposing parties and the judicial system").

Res judicata "extends not only to the precise legal theory presented in the previous litigation, but to all legal theories and claims arising out of the same 'operative nucleus of fact.' " *Olmstead v. Amoco Oil Co.*, 725 F.2d 627, 632 (11th Cir. 1984). *See also Interstate Pipe Maintenance, Inc. v. FMC Corp.*, 775 F.2d 1495, 1497 (11th Cir. 1985) ("final judgment by a court of competent jurisdiction bars a subsequent suit between the same parties and on the same cause of action not only

as to all matters that were litigated in the first proceeding but also as to all issues that could have been litigated"); *John Alden Life Ins. Co. v. Cavendes*, 591 F. Supp. 362, 367 (S.D. Fla. 1984) ("*Res judicata* precludes all claims which might have been made by the parties in the earlier case as well as those issues that were actually litigated").

In *J.D. Marshall International, Inc. v. Redstart, Inc.*, 656 F. Supp. 830 (N.D. Ill. 1987), the district court recognized that a federal judgment can have "full *res judicata* and collateral estoppel effects" on a pending arbitration. The parties had contractually agreed that either one of them could compel arbitration as to claims arising out of the sale of an export business from Redstart to JDM. After differences arose between the parties, JDM filed a federal RICO claim in federal court and a complaint in arbitration. The court observed that, as in the present case, the claims in the two proceedings were based on the same underlying facts: "The predicate offenses JDM alleges in its RICO claims are based entirely on transactions underlying its breach of contract claims in the arbitration proceeding." *Id.* at 834. The court then decided to stay the federal action in recognition of the fact that "[i]f JDM's action here proceeds to judgment first, that judgment would have full *res judicata* and collateral estoppel effects on the arbitration . . . ." *Id.*

Because a judgment rendered in a contemporaneous federal action has res judicata effect on a *pending* arbitration, it irrefutably has the same effect on a *subsequently filed* arbitration. At the outset of this litigation, petitioners had the following choices: (1) file in federal court a 10b-5 and 10b-16 action for only some of their claims and forgo any remaining claims; (2) file in federal court all possible claims, even if the claims that petitioners later sought to arbitrate were inconsistent with petitioners' primary litigation theory; (3) file all claims in arbitration; or (4) proceed simultaneously in litigation and arbitration, recognizing the potential preclusive effect of the decision rendered first. Petitioners chose none of

these options. Instead, they chose the one option that was not available to them. They litigated some of their claims to a conclusion in federal court, lost, and then filed a subsequent arbitration seeking the same recovery. The doctrine of res judicata does not permit that option.

Petitioners do not dispute these basic res judicata principles. Rather, they contend that the arbitration clause in the customer agreements they signed with Merrill Lynch renders the res judicata doctrine ineffective or inapplicable. Petitioners reach this conclusion by two different routes.

First, they argue (Pet. 11-13) that the arbitration clause "is an explicit written consent to the splitting of Petitioners' claims." Second, they assert (Pet. 16) that, as a result of the arbitration clause, "Petitioners were precluded by contract from pursuing their state-law claims in federal court." Both arguments are without merit.

We begin with the language of the arbitration clause. Petitioners' customer agreements with Merrill Lynch provided:

> Except to the extent that controversies involving claims arising under the federal securities laws may be litigated, any controversy between us arising out of such option transactions or this agreement shall be settled by arbitration only before the National Association of Securities Dealers, Inc. or the New York Stock Exchange, or an Exchange located in the United States upon which listed options transactions are executed.

R2-151, at 12-13. This language did not purport to waive the protection of res judicata. It did not even attempt to address the impact that a final federal court judgment would have on a subsequent arbitration. Rather, the arbitration clause merely recognized that, given the state of the law at the time the customer agreements were signed, arbitration of claims under the federal securities laws could not be contractually compelled.

Petitioners simply mischaracterize the nature of the parties' arbitration agreement. The clause is not, as petitioners maintain, an agreement to litigate part of a case and to reserve the rest for resolution in another forum. The agreement neither explicitly nor implicitly authorizes a party to proceed to final judgment in one forum and then to begin the controversy all over again in another, without any concern for the possibility that the first outcome would have a preclusive effect. The arbitration clause did not waive res judicata or any other claim or defense. The clause said nothing about what would happen if securities law claims were litigated to final judgment and petitioners subsequently began an arbitration arising out of the same transactions. Even petitioners do not contend that any such issue was ever actually negotiated and agreed upon by the parties.

Appellants' citation (Pet. 3, 11 n.8) of *Blue Gray Corporations I & II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267 (11th Cir. 1991), is inapposite. *Blue Gray* held only that, under customer agreements like those involved here, Merrill Lynch cannot, from the outset of the proceedings, force a customer to arbitrate a federal securities claim that the customer wants to litigate, and the customer in turn cannot, from the outset of the proceedings, force Merrill Lynch to litigate a state law claim that Merrill Lynch would prefer to arbitrate. Nothing in the court of appeals' opinion or reasoning says or implies anything about the res judicata significance of a final federal court judgment in the context of a later attempt to arbitrate claims arising from the same transactions.

In sum, none of the arguments or authorities advanced by petitioners reveals any waiver of Merrill Lynch's res judicata claim. Nor do petitioners fare any better with their second rationale for opposing Merrill Lynch's position. Contrary to petitioners' contention, nothing in the parties' arbitration clause precluded petitioners from pur-

suing their state law claims in federal court. The fact that Merrill Lynch had the right to compel arbitration of those claims *if* it elected to do so is wholly irrelevant to whether petitioners *could have filed* those claims in the district court in the first instance. There was no requirement that Merrill Lynch move to compel arbitration of those claims.[5] The court of appeals correctly held, therefore, that "[t]he uncertainty of whether [Merrill Lynch] would move to compel arbitration of the state claims did not justify two proceedings." Pet. App. A-6.

Patting themselves on the back, petitioners contend that the "bifurcated proceedings" in this case were "brought about solely because Petitioners complied with an arbitration agreement" between the parties. Pet. 16-17. Petitioners warn that the rule adopted by the court of appeals "will force litigants to breach valid arbitration agreements in order to save their state-law claims from a claim preclusion defense . . . ." Pet. 16. This disingenuous spectre is belied by petitioners' actual conduct in this case. Petitioners were the ones who chose to pursue diametrically inconsistent theories, and petitioners were the ones who chose to wait until they had lost on one theory before making a 180-degree turn and asserting another. Petitioners' predicament is a product of petitioners' own tactical choices and their attempt to manipulate the system so as to enable themselves to take contrary positions without embarrassment or criticism. Their litigation posture has nothing to do with compliance with an arbitration agreement and everything to do with trying to play both ends against the middle.

Finally, petitioners err in suggesting that the decision below is somehow inconsistent with *Clark v. Bear Stearns & Co.*, 966 F.2d 1318 (9th Cir. 1992). The plaintiff

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[5] *See New Process Steel Corp. v. Tital Indus. Corp.*, 555 F. Supp. 1018, 1020 (S.D. Tex. 1983) ("There is no basis in the case law to support the defendants' assertion that simply because a matter may be referable to arbitration, the Court is deprived of jurisdiction.").

in that case did just what petitioners here did not do—she brought *all* of her claims, including both federal securities law claims and state common law claims, in a single federal lawsuit. In response to Bear Stearns' motion, and in accordance with the parties' pre-existing arbitration agreement, the district court then ordered arbitration of the state common law claims; it retained jurisdiction of the federal securities law claims because the parties' agreement did not authorize Bear Stearns to compel arbitration of such claims. The arbitration panel subsequently dismissed all of the common law claims against Bear Stearns.

It was under these circumstances that both the district court and the court of appeals held that the federal securities law claims—*i.e.*, the claims that remained in federal court from the outset—were not barred by res judicata. Those claims were originally filed in federal court, and the federal court at all times retained jurisdiction over them. The plaintiff did not try, as petitioners have here, to proceed first in one forum and then in another.[6]

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[6] Although the court of appeals did not address the point, the injunction preventing petitioners from continuing with their arbitration was also proper because petitioners waived their right to arbitrate. Such a waiver can occur even if it is not subjectively intended. Despite the federal policy favoring arbitration, courts frequently find that a party, by its acts or omissions, has waived its right to compel arbitration. Such a waiver can occur in a variety of circumstances, but it usually arises from delay in requesting arbitration or other conduct that is found to be inconsistent with an arbitration demand, such as engaging in extended discovery or taking other significant litigation steps before seeking to compel arbitration. Here, petitioners waited for more than three years before demanding arbitration and during that period petitioners engaged in protracted litigation, including extensive pre-trial discovery. In such circumstances, courts have held, even in the absence of the preclusive effect of a final judgment, that parties have waived their right to arbitrate. *See, e.g., Midwest Window Systems v. Amcor Industries*, 630 F.2d 535 (7th Cir. 1980); *S & H Contractors, Inc. v. A.J. Taft Coal Co.*, 906 F.2d 1507 (11th Cir. 1990), *cert. denied*, 498 U.S. 1026 (1991); *Stone v. E.F. Hutton & Co.*,

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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898 F.2d 1542 (11th Cir. 1990); *Peterson v. Shearson/American Express, Inc.*, 849 F.2d 464, 467-68 (10th Cir. 1988); *E.C. Ernst, Inc. v. Manhattan Construction Co.*, 551 F.2d 1026 (5th Cir.), *modified on petition for reh'g*, 559 F.2d 268, 269 (5th Cir. 1977), *cert. denied*, 434 U.S. 1067 (1978).

APPENDIX

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

Case No. 87-2445-Civ-NESBITT

FRANK KELLY, MARIA KELLY, ET AL., PLAINTIFFS

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH INC.,
a Delaware corporation, DEFENDANT

CORRECTED ORDER GRANTING SUMMARY JUDGMENT

[Filed Aug. 7, 1990]

The matters pending before the Court are 1) a motion for summary judgment filed by Defendant, Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), 2) Plaintiffs' motion to voluntarily dismiss Count II of the complaint without prejudice, and 3) Plaintiffs' motion to compel answers to interrogatories. After the motions were fully briefed and oral argument heard thereon, the Court enters the following Order.

Statement of the Case

Plaintiff Frank Kelly was a Merrill Lynch account executive who worked at the Merrill Lynch office in Coral Gables. Kelly not only worked at Merrill Lynch but also invested his and his wife's funds through Merrill Lynch. In addition, Kelly advised the remaining Plaintiffs, who

also maintained accounts at Merrill Lynch, concerning their investments.[1]

Between late 1982 and late 1986 each of the Plaintiffs opened securities accounts with Merrill Lynch. In connection with the opening of their accounts, each of the Plaintiffs executed a "Standard Option Agreement" and a "Customer Agreement" prepared by Merrill Lynch that spelled out the risks of option trading. They also received a brochure entitled "Characteristics and Risks of Standardized Options," which Merrill Lynch always supplied customers before permitting them to trade in options. The agreements signed by Plaintiffs clearly provide that Merrill Lynch may at any time require additional collateral for the continued maintenance of their trading positions.

Plaintiffs contend that prior to the time the Plaintiffs commenced trading in short index options, Merrill Lynch represented to Kelly that it would require the following for all trades in short index options by Plaintiffs: [2]

> (a) an initial margin requirement of the greater of the option premium plus 2% of the market value of the underlying index or the option premium plus 5% of the market value of the underlying index any out-of-the-money amount;
>
> (b) a minimum equity in the account of at least $10,000 after all new transactions and subsequent commitments in the account; and

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[1] There are 15 plaintiffs in this action, including 14 individuals and one corporation. The individual and corporate Plaintiffs will be referred to as the individual Plaintiffs or Plaintiffs; Kelly will be referred to by his name or together with the other individual and corporate Plaintiffs.

[2] Prior to the time Plaintiffs opened their accounts, Kelly told each of the Plaintiffs the substance of Merrill Lynch's Equity Requirement and its margin requirements.

(c) a margin maintenance requirement of the greater of the option premium plus 2% of the market value of the underlying index or the option premium plus 5% of the market value of the underlying index or the option premium plus 5% of the market value of the underlying index less any out-of-the-money amount.

Merrill Lynch's requirements for the trading of short index options were in part based upon an exchange-imposed formula for calculating daily margin maintenance requirements as set by the Chicago Board of Options Exchange ("The CBOE") and the New York Stock Exchange ("NYSE"). If an account fell below the margin maintenance requirements, which were subject to change, the customer would receive a "maintenance call," which required the customer to deposit more monies in the account to decrease Merrill Lynch's exposure to losses. It was Kelly's understanding, however, that the equity requirement stated above would not change during the life of Plaintiffs' investment activity.

The options which Kelly and the other Plaintiffs traded were not options to purchase or sell tangible goods or securities. Rather, Plaintiffs chose to invest in Standard & Poor's 100 Stock index ("the S & P 100 index") options, which were traded on the CBOE under the symbol "OEX." Plaintiffs traded in "combinations," the simultaneous sale of put and call options on the same underlying stock index. This kind of trading is profitable only during periods when the market is relatively stable. In an unstable market, one in which the market is subject to violent swings up or down, this kind of trading results in losses. Index options cannot be written on credit, and Defendant did not extend credit to any of the Plaintiffs to purchase or sell the options.

In January 1987, the stock market moved dramatically against the option positions held by Plaintiffs. The S & P 100 index increased steadily from a close of 231.09 on December 31, 1986 to a close of 272.96 on January 30,

1987. The sharp increase of the S & P 100 index was accompanied by a sharp increase in the price of many of the options that Plaintiff had sold short. In turn, the Plaintiffs' financial exposure increased substantially. In late January 1987, in response to unprecedented volatility in the market, Merrill Lynch increased its maintenance requirements. Effective February 6, 1987, Merrill Lynch required Plaintiffs to maintain minimum equity in their accounts of $2,000 per contract or combination. This change in requirements was adopted by Merrill Lynch as a firm-wide policy on March 27, 1987. Some Plaintiffs deposited additional funds to comply with Merrill Lynch's increased requirements; most, however, did not.

By the end of January 1987, all the positions in the Kellys' joint account were closed. As of February 9, 1987, Kelly's individual account was closed. The other Plaintiffs either continued their option trading or merely retained the positions they held at the time the new requirement went into effect, until Merrill Lynch closed their positions. The majority of the other Plaintiffs did not produce the additional funds required by Merrill Lynch before February 6, 1987, or at any time thereafter. During the period from February to April 1987, the market continued to move unfavorably to Plaintiffs and exposed them to increasing losses. As the accounts failed to meet Merrill Lynch's new requirements, Merrill Lynch would liquidate as many of each of Plaintiffs' open option positions as necessary to bring each Plaintiff's account into compliance with the applicable rules. Because the total market price of the options had risen substantially from the time Plaintiffs had sold them to the time Merrill Lynch bought them back to close Plaintiffs' open positions, Plaintiffs realized losses at the time their positions were liquidated. Plaintiffs who continued trading in the Winter of 1987 suffered greater losses than the Plaintiffs whose accounts were first closed by Merrill Lynch. Plaintiffs now seek to recover these losses.

Plaintiffs filed a complaint alleging violations of the federal securities laws. By Count I of the complaint, Plaintiff asserts a Section 10B and 10b-5 claim against Merrill Lynch for its failure to disclose all material facts regarding the terms and conditions applicable to trading short index options at the time the accounts were opened.[3] Specifically, Plaintiffs claim that Merrill Lynch without any prior notice or warning arbitrarily changed its requirements for trading short term options from $10,000 per account to $2,000 per contract or combination. Plaintiffs claim that had they known of this requirement, they would not have engaged in their short index option trading strategy and therefore would not have sustained the losses incurred upon the liquidation of their accounts.

Upon a thorough review of the pertinent portion of the depositions, affidavits and pleadings, the Court finds the Plaintiffs have failed to establish the existence of any genuine issue of material fact with respect to at least one necessary element of a Rule 10-b claim.[4] Plaintiffs have failed to demonstrate that Merrill Lynch acted with scienter.

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[3] Plaintiffs candidly admit that they can obtain all the relief necessary to make them whole through their 10b-5 claim (Count I), and do not want to burden the Court by pursuing the 10b-16 claims as asserted in Count II. Plaintiffs' Memorandum of Law in Opposition to Defendant's Motion for Summary judgment, filed February 13, 1990 at page 2.

[4] Although the complete absence of any evidence of scienter, discussed *infra*, is reason enough for this Court to grant Defendant summary judgment, the Court also finds that Plaintiffs have failed to adduce any evidence that the misrepresentation or omission caused Plaintiffs' loss, which is an essential element of Plaintiffs' claim. *See Rousseff v. E.F. Hutton Co., Inc.*, 843 F.2d 1326 (11th Cir. 1988). Plaintiffs' loss was clearly the result of adverse market trends unconnected to Defendant's misrepresentations, and there is no guaranty that Plaintiffs would not have lost even more money had they continued to trade.

DISCUSSION

1. *The Scienter Requirement*

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative device or contrivance." 15 U.S.C. §78j(b). Rule 10b-5, promulgated by the Securities Exchange Commission, pursuant to Section 10(b), prohibits any artifice to defraud or any act which "operates or would operate as a fraud or deceit." 17 C.F.R. § 240.10b-5. A successful cause of action under Section 10(b) requires that the plaintiff demonstrate each of the following five factors: (1) a misstatement or omission, (2) of a material fact (3) made with scienter (4) upon which the plaintiff relied (5) that proximately causes plaintiff's loss. *McDonald v. Alan Bush Brokerage Company*, 863 F.2d 809, 814 (11th Cir. 1989).

In *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1381 (1976), the Supreme Court held that, to recover under Rule 10b-5, a plaintiff must plead and prove scienter in connection with a misrepresentation or omission to state material facts. Scienter is "an intent to deceive, manipulate or defraud." *Ernst*, 96 S. Ct. at 1381 n.12. In *Ernst*, the Supreme Court left open the question of whether scienter comprises not only malicious intent but also reckless disregard for the truth. The Eleventh Circuit, however, has held that a showing of "severe recklessness" can satisfy the scienter requirement. *See McDonald, supra.* The court has defined narrowly the circumstances under which actions or omissions could rise to the level of severe recklessness:

> 'Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simply or ever excusable negligence, but extreme departure from the standards of ordinary

> care, and that present in danger of misleading buyers or sellers which is either known to the Defendant or so obvious that the defendant must have been aware of it.'

McDonald, 863 F.2d at 814 (quoting *Broad v. Rockwell International Corp.*, 642 F.2d 929 (5th Cir.) (*en banc*), *cert. den.*, 102 S. Ct. 506 (1981)).

In the complaint, Plaintiffs have alleged that Merrill Lynch committed fraud by failing to disclose that the Equity Requirement was subject to change when the accounts were opened. However, much of Plaintiffs' argument focuses on Merrill Lynch's behavior in early 1987 when Merrill Lynch "changed the rules" and "arbitrarily changed its Equity Requirement for trading short index options in *January 1987*." (Plaintiffs' Memorandum pp. 13-14, 17-18).

Plaintiffs cannot rely on Merrill Lynch's conduct in January 1987 to prove scienter at the time the alleged fraud took place, *i.e.*, when the customers accounts were opened. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 546 (5th Cir. 1981), *aff'd in part and rev'd in part*, 103 S. Ct. 683 (1983) ("whether a Defendant's action in a Rule 10b-5 case violate the standard of care imposed by the Rule . . . is to be determined as of the time of the actions complained of."). Plaintiffs must prove that Merrill Lynch acted with scienter when they failed to disclose material facts to Plaintiffs.

Plaintiffs have alleged that Merrill Lynch acted intentionally with severe recklessness, but have not offered any evidence which shows that Merrill Lynch acted with such culpability, whether at the time the accounts were opened, or in January 1987. A review of the evidence in the record reveals only one serious attempt to introduce proof on the issue of scienter. Plaintiffs' expert witness, Frank Ibarra, states in paragraph 41 of his affidavit that

> It is my opinion that Merrill Lynch's failure to disclose to Plaintiffs that it could change its Equity Requirement . . . was highly unreasonable and constituted an extreme departure from the standard of ordinary care expected of a broker/dealer in securities. It is also my opinion that Merrill Lynch's failure to disclose to Plaintiffs that it could change its Equity Requirement . . . presented a danger of misleading Plaintiffs which was either known to Merrill Lynch or was so obvious that Merrill Lynch must have been aware of it . . . . In short, I believe that Merrill Lynch was severely reckless in its dealings with Plaintiffs and caused Plaintiffs to sustain tremendous losses.

Mr. Kelly makes similar conclusory allegations regarding Merrill Lynch's conduct. Such statements cannot create an issue of material fact regarding scienter. As stated by the Eleventh Circuit, "[t]his court has consistently held that conclusory allegations without specific supporting facts have no probative value." *Evers v. General Motors Corp.*, 770 F.2d 984 (11th Cir. 1985). Although purportedly based upon a review of the relevant evidence, Mr. Ibarra's affidavit fails to provide any factual support for his opinions. Thus, his conclusions regarding "severe recklessness" do not create an issue which precludes summary judgment. Nor do Mr. Kelly's allegations, which are equally devoid of factual support.

Plaintiffs' theory of the case is that as the customer agreements,[5] signed when they opened their accounts in

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[5] At the time the Plaintiffs opened their accounts they signed a standard Customer Agreements which provided that Merrill Lynch had the right to require additional collateral:

> (1) in accordance with its general policies regarding its margin maintenance requirements, as such may be modified, amended, or supplemented from time to time; or
>
> (2) if in Merrill Lynch's discretion it considers it necessary for its protection at an earlier or later point in time than called for by said general policies. . . .

1984, referred only to margin maintenance requirements as collateral, and were silent as to equity, Merrill Lynch recklessly omitted to disclose to Plaintiffs that it could increase its equity requirements, as it did in January 1987. In fact, Kelly states that Merrill Lynch led him to believe that the equity requirement would not change.[6] As a consequence, the Plaintiffs claim they were induced to open their margin accounts without being told this necessary information for trading short index options. As alleged in the complaint, this omisssion constituted a "scheme or artifice to defraud the Plaintiffs," the purpose of which was to "induce Plaintiffs to open their respective margin accounts and to purchase and sell securities to their detriment." (Complaint paragraphs 34-35).

Plaintiffs have offered no evidence, circumstantial or otherwise, that Plaintiff made statements or omissions to "induce Plaintiffs . . . to purchase and sell securities to their financial detriment." Merrill Lynch is in the business of securing customers who will make money, not lose money as alleged, and Plaintiffs have introduced absolutely no proof to the contrary.

Even assuming Merrill Lynch should have spelled out in detail each and every form which additional collateral could take once more money was required to cover losses in the customer's account,[7] Merill Lynch's failure to dis-

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[6] The fact that Merrill Lynch represented orally to Plaintiffs its equity requirements for trading in short index options would not preclude recovery. The Eleventh Circuit has recognized that an investor may under certain circumstances rely on oral misrepresentation to recover under Rule 10b-5. *Bruschi v. Brown*, 876 F.2d 1526, 1529 (11th Cir. 1989). In considering the evidence in the light most favorable to the Plaintiff, the Court regards this allegation as true, notwithstanding that this representation is not in the Customer Agreement.

[7] The parties have presented a great deal of evidence by affidavits and otherwise regarding the distinction between "margin" and "equity." For the purpose of this Order the Court will not resolve

close amounts to, at most, an "inadvertent oversight" insufficient to establish scienter. *Dwoskin v. Rollins, Inc.*, 634 F.2d 285, 301 (5th Cir. 1981). Moreover, even if Kelly were advised by Merrill Lynch that its "minimum equity requirement of $10,000 per account . . . would remain constant . . . regardless of the number of option portions held and regardless of the relationship between those positions and the market value of the underlying index," (Kelly affidavit, p.4, paragraph 11), this is not sufficient to demonstrate a "deliberate or intentional scheme to manipulate." *Fryling v. Merrill Lynch Pierce, Fenner & Smith*, 593 F.2d 736, 743 (6th Cir. 1979). Reasonable investors should have known that they would be called upon to cover their obligations when their accounts began to reflect losses. *Eriksson v. Galvin*, 484 F. Supp. 1108 (S.D.N.Y. 1980) ("no duty to disclose information to one who reasonably should already be aware of it."); *see also Zerman v. Ball*, 735 F.2d 15 (2nd Cir. 1984) (withheld information so basic any investor should shown of it.)

In *Prudential-Bache Securities Inc. v. Stricklin*, 890 F.2d 704 (4th Cir. 1989), Associate Justice Powell discussed the relationship between a brokerage house and customer when dealing in short term options. Referring to a particular customer agreement provision allowing for liquidation without notice, he stated that

> Such provisions are reasonable in the volatile and risky put options market. A brokerage house should not have to risk a nearly unlimited amount of its

---

this esoteric disagreement, which the Court deems a distinction without a difference. However, no reasonable investor could fairly believe that when losses began to occur in their account, Merrill Lynch could not request increased collateral to cover those losses, regardless of the nomenclature. The Court will assume for the purpose of this Order that the Plaintiffs have presented sufficient evidence to create an issue of fact as to the differences in the terms.

> own funds . . . while waiting 24 hours to see if a client can meet a margin call.
>
> * * *
>
> Furthermore, even without reliance . . . on the Client Agreement, appellee would be entitled to judgment as a matter of law. In general an individual who opens a brokerage account is responsible to the brokerage house for losses on that account.

Id. at 707.

Clearly, the reasonable investor should know that the brokerage house is not required to risk its own funds on behalf of its customers.

In a Section 10b action, a plaintiff carries a heavy burden: "[m]ost significantly he must prove that the defendant acted with scienter . . . ." *Herman & MacLean v. Huddleston*, 103 S. Ct. 683, 687 (1983). The Court recognizes that "proof of defendant's knowledge or intent [in a Rule 10-5 action] will often be inferential," and that circumstantial evidence can be sufficient to withstand a motion for directed verdict as to a material element. *Herman*, 640 F.2d at 546-547. Nevertheless, taken in light most favorable to Plaintiffs, Plaintiffs' allegations are such that no reasonable juror could conclude that Merrill Lynch's original disclosures were so lacking so as to infer the presence of "severe recklessness" or the "intent to deceive, manipulate or defraud." Merrill Lynch clearly disclosed that it could require additional collateral at any time, and that it could liquidate Plaintiffs' accounts if the collateral was not provided. Moreover, it is not alleged that Merrill Lynch promised Plaintiffs that it would always accept premiums from newly-written options to meet its collateral requirements. Clearly, such a scenario would pose a substantial, and unreasonable, risk for Merrill Lynch.[8]

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[8] Plaintiffs' entire argument is predicated on the theory that they should have been allowed to ride out any unfavorable movement in the market by supplying premiums from newly-written options as

Plaintiffs' alternative theory of fraud, which is raised in the complaint, is that Merrill Lynch failed to disclose adequately the new equity or collateral requirements in January 1987.

The typical January 1987 letter from J. Guillermo Castro, Vice President of Merrill Lynch's Coral Gables Branch read as follows:

> I am writing you in order to assure myself that you are aware of the recent movements of the stock market. I am attaching, hereto, an article that appeared in the New York Times magazine about what is happening in the market. As you can see, the volatility was so great, it was unprecedented.
>
> Due to this volatility, our firm has imposed stricter requirements regarding short term options. The minimum requirements have been doubled.
>
> Your account currently has the necessary balance to cover your current position. However, certain setbacks have occurred during the past two weeks that you should be aware of in order to decide whether or not you wish to remain in the market. In the event you wish to withdraw from the program, as of the close of business on Monday, January 26, your account had a balance of $32,144.

Although the letters were different with respect to certain aspects of each account, all Plaintiffs were sent an essentially identical letter notifying them of the changes in the equity requirements. Specifically, Plaintiffs were notified that Merrill Lynch had increased the requirements for maintaining their positions. The nature of the new requirement was described, and Plaintiffs were told

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collateral. Such a strategy is obviously unsound, to say the least, because the premiums are only a short-term gain and writing additional options would expose the Plaintiffs to even greater losses. Plaintiffs could not realistically expect their strategy to work indefinitely under any adverse market conditions.

whether additional collateral was immediately required. If additional collateral were not required immediately, Plaintiffs were informed that additional collateral might be required in the future. Plaintiffs were also told that if the equity in their accounts fell below the requisite levels, some or all of their positions could be liquidated without further notice. Although some Plaintiffs allege that they did not receive this letter, the evidence is uncontroverted that Merrill Lynch mailed these letters to Plaintiffs in a timely fashion.

Moreover, there is no evidence that Merrill Lynch's decision to raise the equity requirements was motivated by malice towards Plaintiffs. Advising the client that because of "movements in the stock market" that "stricter requirements regarding short term options would be imposed" and requiring additional collateral does not rise to "conduct so extreme as to be the form of intentional conduct or behavior equivalent to deceive, manipulate, or defraud." *Huddleston v. Herman, supra.* By its very language the stricter requirements regarding short term options were "due to unprecedented volatility in the market." Kelly has asserted in his affidavit that Merrill Lynch's rule change was "arbitrary and wrongful" and that Merrill Lynch engaged in a "deceitful course of business and material nondisclosure," which prevented Plaintiffs from reversing their setbacks. (Kelly affidavit, paragraphs 39 and 41). Plaintiffs have evidenced disenchantment with their losses, but little else. No evidence has been presented that Merrill Lynch's actions were such an extreme departure from the standards of ordinary care to support a 10-b claim.

Kelly was an experienced broker and was acting as a representative for the other Plaintiffs in their dealings with Merrill Lynch. Merrill Lynch made sure that Plaintiffs were aware they were trading in a volatile and risky area. For example, on each option agreement there is a notation in capital letters stating that the customer has re-

ceived and read a booklet describing the risks and uses of options and that the customer is aware of the special risks attendant to option trading. Merrill Lynch acted in accordance with the customer agreements which expressly authorized it to impose new requirements for maintaining their option accounts in open positions and to liquidate Plaintiffs positions if such requirements were not met. Even if the Plaintiffs are correct that it was unreasonable for Merrill Lynch to increase to "equity requirements," it has not shown Merrill Lynch's misrepresentation or omission to be "severely reckless." Unreasonableness does not meet the standard for scienter. *McDonald,* 863 F.2d at 815.

In summary, Plaintiffs have made no showing that Merrill Lynch's alleged omissions and statements represented an extreme departure from the standards of ordinary care and presented a danger of misleading Plaintiffs which was either known to Merrill Lynch or was so obvious they must have been aware of it. Neither have Plaintiffs adduced any proof that at time the Plaintiffs opened their accounts or in January 1987 that Merrill Lynch acted with evil motive or intent to deceive, manipulate, or defraud so that, as alleged in the complaint, Plaintiffs would be induced to "open their respective margin accounts with Merrill Lynch and to purchase and sell securities to their financial detriment."

2. *Summary Judgment*

Federal Rule of Civil Procedure 56(c) provides that summary judgment shall be granted if "there is no genuine issue as to any material fact and [if] the moving party is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(c). Rule 56(c) mandates summary judgment against a party who fails to make a showing sufficient to establish the existence of an element essential to the case, on which that party will bear the burden of proof at trial. *Celotex Corp. v. Catrett,* 106 S. Ct. 2548, 2552-53 (1986). Further, the non-moving party

must raise an issue for trial by showing that there is sufficient evidence for a jury to return a verdict for the non-moving party. If the evidence is merely colorable or not significantly probative, summary judgment will be granted. *Anderson v. Liberty Lobby, Inc.*, 106 S. Ct. 2505, 2510-11 (1986).

Under Rule 56(e) a party opposing a summary judgment motion must "set forth specific facts showing there is a genuine issue for trial." This means that sufficient probative evidence must be identified under which the non-moving party would be entitled to prevail. The Plaintiffs cannot rest on their allegations of scienter without "any significant probative evidence of scienter to support the complaint." *Anderson*, 106 S. Ct. at 2510.

A mere scintilla of evidence will not do, for a jury is permitted to draw only those inferences of which the evidence is reasonably susceptible; it may not resort to speculation. *Mutual Fund Investors v. Putnam Management Co.*, 553 F.2d 620, 624 (9th Cir. 1977).

The potential for abuse of 10b-5 actions has been recognized by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917, 1927 (1975). Although Plaintiffs may feel wronged by Merrill Lynch's disclosures both at the time the accounts were opened and in February 1987 when the requirements for trading index options were changed, Plaintiffs have not shown any specific facts that Merrill Lynch's conduct was "so extreme as to be the form of intentional conduct or behavior equivalent to an intent to deceive or defraud."

After discovery has been completed, as in this case, the Supreme Court has held that the entry of a summary judgment is mandatory against a party failing to show the existence of an essential element to prevail at trial. *Celotex Corp. v. Catrett*, 106 S. Ct. at 2552. Factual disputes that are irrelevant will not be counted. In determining what is a material fact, "the substantive law

will identify which facts are material" and the Court must evaluate the evidence presented by the substantive evidentiary burden." *Brown v. Crawford,* Case No. 89-5927 (11th Cir. July 24, 1990).[9]

Under the appropriate materiality analysis, Plaintiffs have failed to demonstrate a necessary element in countering the summary judgment motion; they have not shown a genuine issue of fact as to scienter. As stated above, Plaintiffs have made no showing that the Defendant alleged statements and omissions represented an extreme departure from the standards of ordinary care which presented a danger of misleading Plaintiffs which was either known to Defendants or so obvious they must have been aware of it.

Conclusion

For the reasons stated in this Order, it is

ORDERED AND ADJUDGED that Merrill Lynch's motion for summary judgment is GRANTED as to Count I of the complaint, for the reasons stated above. It is further

ORDERED AND ADJUDGED that Plaintiffs' motion to dismiss Count II of the complaint is GRANTED in part. Count II of the complaint is DISMISSED with prejudice, for the reasons stated by the Court at the hearing on June 11, 1990. It is further

ORDERED AND ADJUDGED that Plaintiffs' motion to compel answers to interrogatories is DENIED as moot.

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[9] At oral argument Plaintiffs urge that under Merrill Lynch's internal procedure manual, they were prohibited from raising their Equity Requirements. Even if this contention were true, violation of internal policies do not rise to the level of law or public policy and so does not raise a genuine issue of material fact with regard to scienter. *Thomson McKinnon Securities v. Clark,* 901 F.2d 1568 (11th Cir. 1990) ("whether the firms non-trading policy was in place . . . is not a genuine issue of material fact that would preclude summary judgment.").

A separate final judgment was entered on August 6, 1990. The Court reserves jurisdiction for the assessment of appropriate costs.

DONE and ORDERED in chambers, Miami, Florida this 7th day of August 1990.

/s/ Lenore C. Nesbitt
LENORE C. NESBITT
United States District Judge

cc: counsel of record

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No. 93-486

In The

Supreme Court of the United States

October Term, 1993

FRANK KELLY, MARIA KELLY, JUAN ANTONIO BRANDO, BERTA LASERNA, RAFAEL DAVID POLEO ISAVA, ELLIO CIOCCA, DANIEL PRADO FLORES, MAX GOMEZ, WILLIAM MACKAY, ANTONIA MACKAY, GONZALO BARQUERO, ABRAHAM STEFAN, OSVALDO CORDOVA, RUDY ZEPEDA, THOMAS BOVEE, RICARDO SUCRE, and AGROPECUARIA MILLON, C.A., a foreign corporation,

Petitioners,

vs.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Delaware corporation,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

REPLY TO BRIEF IN OPPOSITION

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In The

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Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

REPLY TO BRIEF IN OPPOSITION

Respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") has released a torrent of irrelevancies in a valiant but unsuccessful effort to obscure the

relatively straightforward legal issues as to which Petitioners* seek this Court's review: (1) whether issues of *res judicata* are an exception to the federal policy requiring enforcement of valid pre-dispute arbitration agreements; and (2) whether a party who executes an agreement requiring or permitting bifurcated judicial and arbitral proceedings may nevertheless urge in defense that the plaintiff has split his claim. Petitioners respectfully suggest that these issues are worthy of this Court's consideration, and that the petition for certiorari should be granted.

We reply briefly to Merrill Lynch's principal arguments below.

A. *The court of appeals ignored the important federal policy reflected in the Federal Arbitration Act.* Merrill Lynch argues that "[t]he Federal Arbitration Act does not address the question of how a claim of *res judicata* based on a district court judgment should be resolved. . . ." Brief at 10. In fact, this Court more than 25 years ago interpreted the Federal Arbitration Act to provide that, when presented with a dispute covered by an enforceable arbitration agreement, a district court "may consider *only* issues relating to the making and performance of the agreement to arbitrate." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967) (emphasis added). *Res judicata* relates to neither. *Res judicata* is instead an affirmative defense to the underlying claim, *see* Fed. R. Civ. P. 8(c), and, like other such defenses, should be

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* The single corporate Petitioner has no parent companies or subsidiaries.

referred to arbitration and resolved by the arbitrators in the course of resolving the underlying claim.[1] The proposition that defenses to arbitrable claims are themselves arbitrable is simply an application of the general rule that "[p]arties who agree to submit matters to arbitration are presumed to agree that everything, both as to law and fact, necessary to render an ultimate decision is included in the authority of the arbitrators." *Ormsbee Dev. Co. v. Grace*, 668 F.2d 1140, 1146 (10th Cir.), *cert. denied*, 459 U.S. 838 (1982).

Merrill Lynch suggests that these normal procedures are somehow altered by the fact that a court was involved in rendering the judgment on which the defense of *res judicata* is based, but fails to articulate or explain the basis for that suggestion. It is hardly normal or commonplace for a rendering court to pass on the preclusive effect of its own judgment. *See Donovan v. City of Dallas*, 377 U.S. 408, 412 (1964) (litigants had a right to pursue their claims in

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[1] *See e.g., Lawrence v. Comprehensive Business Services Co.*, 833 F.2d 1159 (5th Cir. 1987) (illegality); *Saturday Evening Post Co. v. Rumbleseat Press, Inc.*, 816 F.2d 1191, 1198-99 (7th Cir. 1987) (invalidity of copyright as defense to claim for breach of license agreement); *Mar-Len of Louisiana, Inc. v. Parsons-Gilbane*, 773 F.2d 633, 636 (5th Cir. 1985) (economic duress); *Rhone-Poulenc Specialities Chimiques v. SCM Corp.*, 769 F.2d 1569, 1572 (Fed. Cir. 1985) (scope, validity and infringement of patent as defense to claim for breach of license agreement); *County of Durham v. Richards & Assoc., Inc.*, 742 F.2d 811, 815 (4th Cir. 1984) (statute of limitations); *Sauer-Getriebe KG v. White Hydraulics, Inc.*, 715 F.2d 348, 350 (7th Cir. 1983) (lack of consideration, unconscionability and vagueness), *cert. denied*, 464 U.S. 1070 (1984); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu*, 637 F.2d 391, 398 (5th Cir. Feb. 19, 1981) (duress and unconscionability).

federal court, despite defense of *res judicata*, and "whether or not a plea of *res judicata* in the second suit would be good is a question for the [second] court to decide"); 18 C. Wright et al., *Federal Practice and Procedure* § 4404 at 32 (1981) ("Ordinarily both issue preclusion and claim preclusion are enforced by awaiting a second action in which they are pleaded and proved by the party asserting them"). These and hundreds of other authorities stand for the proposition that *res judicata* is in the first instance a defense rather than a basis for injunctive relief. Given the important federal policies embodied in the Federal Arbitration Act, there is even more reason than usual for Merrill Lynch's *res judicata* defense to be considered and resolved by means of arbitration, as the parties agreed, rather than by the rendering court.

Similarly, Merrill Lynch simply begs the question when it insists that "[t]he federal policy favoring arbitration is not implicated until the district court has had an opportunity to decide . . . whether or not all claims have already been resolved by prior litigation." Brief at 14. Petitioners' rights under the Merrill Lynch arbitration agreement and the Federal Arbitration Act *include* the right to an arbitral determination of "whether or not all claims have already been resolved by prior litigation." One could just as well argue that the federal policy favoring arbitration is not "implicated" until a district court decides whether the claims in arbitration can survive a statute of limitations defense. Yet it is settled that such a defense is subject to arbitration. *See e.g., County of Durham v. Richards & Assoc., Inc.*, 742 F.2d 811, 815 (4th Cir. 1984).

B. *The court of appeals created a perverse and untenable rule of res judicata.* Merrill Lynch is mistaken in contending that Petitioners refrained from pursuing their common-law claims in the federal securities litigation in order to preserve their credibility before the district court. Brief at 6.[2] Petitioners refrained from pursuing their common-law claims in the federal litigation because they had agreed not to litigate those claims. *See Blue Gray Corporations I and II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267, 271 (11th Cir. 1991) (arbitration agreement containing identical language "clearly provided for state law claims to be arbitrated, even those which arise out of the same transactions or occurrences as federal securities law claims").[3]

More fundamentally, much of Merrill Lynch's argument appears to rest on the premise that only *defendants* are permitted to invoke a contractual right to arbitrate. *E.g.*, Brief at 7 (characterizing Petitioners' argument as an argument that Petitioners' common-law claims could not

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[2] Merrill Lynch makes much of the supposed "inconsistency" between the claims raised before the district court and those raised before the NASD arbitration panel, but never attempts to explain how that supposed inconsistency bears on the issues before this Court. If Merrill Lynch believes that Petitioners' arbitrable claims violate the doctrine of judicial estoppel or some other unidentified limitation on taking inconsistent position in successive proceedings, it is free to raise that argument before the arbitration panel.

[3] *J.D. Marshall Int'l, Inc. v. Redstart, Inc.*, 656 F. Supp. 830 (N.D. Ill. 1987), to which Merrill Lynch devotes half a page of its brief, did not involve an agreement to bifurcate proceedings of the sort involved here. Our argument against the application of *res judicata* is based on the existence of such an agreement.

have been raised in the federal action "because Merrill Lynch could have sought to compel arbitration of those claims"); *id.* at 19 ("There was no requirement that Merrill Lynch move to compel arbitration of those claims"). Even in the sole instance where Merrill Lynch appears to acknowledge that the right to arbitrate is symmetrical, it is uncommonly grudging in its description of that right. *See id.* at 9 (the Merrill Lynch arbitration agreement "simply enabled either party to compel arbitration of state law claims"). Apparently, Merrill Lynch is advancing the notion that the arbitration agreement gave Petitioners the right to *compel* arbitration (of what?) but not the right to initiate arbitration in the first instance. The basis for that view is not explained.[4]

In fact, by providing that claims other than federal securities claims "*shall*" be arbitrated, the Merrill Lynch arbitration agreement not only *permitted* but *required* Petitioners to arbitrate their common-law claims, and Petitioners properly honored that agreement. They should hardly be penalized for doing so. What Merrill Lynch denigrates as a "disingenuous spectre" (Brief at 19) is in fact an unavoidable consequence of the rule adopted by the court of appeals. If the lower courts' ruling is permitted to stand, securities plaintiffs will have no practical

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[4] Likewise, Merrill Lynch's observation that the language of the agreement "merely recognized" that arbitration of federal securities claims "could not be contractually compelled" (Brief at 17) is inconsistent with the law of most circuits and, indeed, with the law of this case. *See Blue Gray Corporations I and II v. Merrill Lynch*, 921 F.2d at 271 ("The arbitration clause in this case did more than merely notify the plaintiff of the existing state of the law; it expressed the agreement between the parties").

choice but to breach valid arbitration agreements and submit to already overburdened federal courts claims which would otherwise be resolved in extrajudicial arbitration. That result will not be limited, as Merrill Lynch contends, to situations in which the plaintiff's federal claims and arbitrable claims are (in Merrill Lynch's estimation) "inconsistent."[5]

Under section 26(1)(a) of the Second Restatement of Judgments, the defense of *res judicata* is unavailable where "[t]he parties have agreed in terms or in effect that the plaintiff may split his claim." Although Merrill Lynch does not discuss section 26 in its opposing brief, it has previously acknowledged that section 26 is an accurate statement of federal common law. Moreover, as the Eleventh Circuit recognized below, the Merrill Lynch arbitration agreement is undeniably an agreement of the kind described in the Restatement. *See* 985 F.2d at 1070 ("The [Merrill Lynch arbitration] agreement . . . allowed plaintiffs to institute two suits based on the same events"). It follows that the lower courts erred in holding that Merrill Lynch has a valid *res judicata* defense. Because of the

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[5] Merrill Lynch's attempt to distinguish *Clark v. Bear Stearns & Co.*, 966 F.2d 1318 (9th Cir. 1992), is unpersuasive. As Merrill Lynch itself acknowledges (at page 16), a judgment is ordinarily entitled to preclusive effect even when both proceedings have been put into motion simultaneously. Thus, under the Eleventh Circuit's reasoning in this case, the plaintiff's federal securities claims in *Clark* should have been barred by the preclusive effect of the prior arbitration. In our view, the Ninth Circuit's rejection of that result was implicitly based on the recognition that the parties had agreed to the splitting of the plaintiff's claims.

potentially far-reaching consequences of that ruling, Petitioners respectfully suggest that this Court should grant certiorari in order to review the decision of the court of appeals.

CONCLUSION

Petitioners respectfully contend that the petition for certiorari should be granted.

Respectfully submitted,

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